Evaluation Report

The IMF and Argentina, 1991–2001

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The following symbols have been used throughout this report:

– between years or months (e.g. 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g. 2003/04) to indicate a fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. Under the current policy on public access to the IMF's archives, some of these documents will become available five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other documents are to become available ten or twenty years after their issuance depending on the series.

Preface

This report evaluates the role of the IMF in Argentina during 1991–2001, focusing particularly on the period of crisis management from 2000 until early 2002. It was prepared by a team headed by Shinji Takagi and including Benjamin Cohen, Isabelle Mateos y Lago, Misa Takebe, and Ricardo Martin. It also benefited from substantive contributions from Nouriel Roubini and Miguel Broda. The report was approved by Montek S. Ahluwalia, then Director of the Independent Evaluation Office (IEO). Research assistance and logistical support in Argentina from Nicolas Arregui; administrative support by Annette Canizares, Arun Bhatnagar, Maria Gutierrez, and Florence Conteh; and editorial work by Ian McDonald and Esha Ray are gratefully acknowledged.

In keeping with standard IEO procedures, parties whose actions and decisions were evaluated, including IMF staff and previous Argentine authorities, were given a chance to comment on a draft of the report, but the final judgments are the responsibility of the IEO alone. The final version of the report was submitted to IMF management for comments, and also circulated simultaneously to Executive Directors. The report, with management and staff comments and the IEO response, was discussed by the Executive Board on July 26, 2004. The report is being published as discussed by the Board, along with a statement to the Executive Board by the Governor of the IMF for Argentina and the Chairman's Summing Up of the Board discussion.

The IEO was created in 2001 to provide objective and independent evaluations on issues relevant to the IMF. It operates independently of IMF management, and at arms' length from the IMF Executive Board.

Abbreviations and Acronyms

CBA	Currency board arrangement
CET	Common external tariff
DSA	Debt sustainability analysis
EFF	Extended Fund Facility (IMF)
FAD	Fiscal Affairs Department (IMF)
FIN	Finance Department (IMF)
G-7	Group of Seven countries
G-10	Group of Ten countries
ICM	International Capital Markets Department (IMF)
IDB	Inter-American Development Bank
IEO	Independent Evaluation Office (IMF)
IFI	International financial institution
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (IMF)
LIBOR	London interbank offered rate
LOI	Letter of intent (IMF)
MAE	Monetary and Exchange Affairs Department (IMF)[1]
MERCOSUR	Mercado Común del Sur
NDA	Net domestic assets
NFPS	Nonfinancial public sector
NIR	Net international reserves
NPV	Net present value
PAYG	Pay-as-you-go
PBG	Policy-based guarantee (World Bank)
PDR	Policy Development and Review Department (IMF)
PSI	Private sector involvement
REER	Real effective exchange rate
RES	Research Department (IMF)
SBA	Stand-By Arrangement (IMF)
SDR	Special drawing right (IMF)
SRF	Supplemental Reserve Facility (IMF)
TRE	Treasurer's Department (IMF)[2]
VAT	Value-added tax
WEO	World Economic Outlook (IMF)
WHD	Western Hemisphere Department (IMF)

[1]Effective May 1, 2003, name was changed to Monetary and Financial Systems Department.
[2]Effective May 1, 2003, name was changed to Finance Department.

The IMF and Argentina, 1991–2001

Executive Summary

The Argentine crisis of 2000–02 was among the most severe of recent currency crises. With the economy in a third year of recession, in December 2001, Argentina defaulted on its sovereign debt and, in early January 2002, the government abandoned the convertibility regime, under which the peso had been pegged at parity with the U.S. dollar since 1991. The crisis had a devastating economic and social impact, causing many observers to question the role played by the IMF over the preceding decade when it was almost continuously engaged in the country through five successive financing arrangements.

Overview

The convertibility regime was a stabilization device to deal with the hyperinflation that existed at the beginning of the 1990s, and in this it was very successful. It was also part of a larger Convertibility Plan, which included a broader agenda of market-oriented structural reforms designed to promote efficiency and productivity in the economy. Under the Convertibility Plan, Argentina saw a marked improvement in its economic performance, particularly during the early years. Inflation, which was raging at a monthly rate of 27 percent in early 1991, declined to single digits in 1993 and remained low. Growth was solid through early 1998, except for a brief setback associated with the Mexican crisis, and averaged nearly 6 percent during 1991–98. Attracted by a more investment-friendly climate, there were large capital inflows in the form of portfolio and direct investments.

These impressive gains, however, masked the emerging vulnerabilities, which came to the surface when a series of external shocks began to hit Argentina and caused growth to slow down in the second half of 1998. Fiscal policy, though much improved from the previous decades, remained weak and led to a steady increase in the stock of debt, much of which was foreign currency denominated and externally held. The convertibility regime ruled out nominal depreciation when a depreciation of the real exchange rate was warranted by, among other things, the sustained appreciation of the U.S. dollar and the devaluation of the Brazilian real in early 1999. Deflation and output contraction set in, while Argentina faced increasingly tighter financing constraints amid investor concerns over fiscal solvency.

The 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. The IMF on its part erred in the precrisis period by supporting the country's weak policies too long, even after it had become evident in the late 1990s that the political ability to deliver the necessary fiscal discipline and structural reforms was lacking. By the time the crisis hit Argentina in late 2000, there were grave concerns about the country's exchange rate and debt sustainability, but there was no easy solution. Given the extensive dollarization of the economy, the costs of exiting the convertibility regime were already very large. The IMF supported Argentina's efforts to preserve the exchange rate regime with a substantial commitment of resources, which was subsequently augmented on two occasions. This support was justifiable initially, but the IMF continued to provide support through 2001 despite repeated policy inadequacies. In retrospect, the resources used in an attempt to preserve the existing policy regime during 2001 could have been better used to mitigate at least some of the inevitable costs of exit, if the IMF had called an earlier halt to support for a strategy that, as implemented, was not sustainable and had pushed instead for an alternative approach.

Surveillance and Program Design, 1991–2000

Exchange rate policy

The convertibility regime was enormously successful in achieving price stability quickly. Although the IMF was initially skeptical of its medium-term viability, its internal views as well as public statements became much more upbeat when Argentina—with financial support from the IMF—successfully weathered the aftermath of the Mexican crisis, endorsing

the convertibility regime as essential to price stability and fundamentally viable. Little substantive discussion took place with the authorities on whether or not the exchange rate peg was appropriate for Argentina over the medium term, and the issue received scant analysis within the IMF.

Following the devaluation of the Brazilian real in early 1999, IMF staff began to consider more seriously the viability of the peg and possible exit strategies. However, consistent with established practice, but contrary to recent Executive Board guidelines, the issue was not raised with the authorities in deference to the country's prerogative to choose an exchange rate regime of its own liking. Neither was the issue brought to the attention of the Executive Board. Not only was the staff concerned that discussion of exchange rate policy, if leaked to the public, might cause a self-fulfilling speculative attack on the currency, but it also knew from its analytical work that the risks and costs associated with any exit from convertibility were already very high.

Fiscal policy

The choice of the convertibility regime made fiscal policy especially important. Given the restrictions on use of monetary policy, debt needed to be kept sufficiently low in order to maintain the effectiveness of fiscal policy as the only tool of macroeconomic management and the ability of the government to serve as the lender of last resort. Fiscal discipline was also essential to the credibility of the guarantee that pesos would be exchanged for U.S. dollars at par. Fiscal policy was thus rightly the focus of discussion between the IMF and the authorities throughout the period. While fiscal policy improved substantially from previous decades, the initial gains were not sustained, and the election-driven increase in public spending led to a sharp deterioration in fiscal discipline in 1999. As a result, the stock of public debt steadily increased, diminishing the ability of the authorities to use countercyclical fiscal policy when the recession deepened.

The IMF's surveillance and program conditionality were handicapped by analytical weaknesses and data limitations. The IMF's focus remained on annual fiscal deficits, when off-budget operations, notably the court-ordered recognition of old debt, were raising the stock of debt. Insufficient attention was paid to the provincial finances, the sustainable level of public debt for a country with Argentina's economic characteristics was overestimated, and debt sustainability issues received limited attention. These deficiencies were understandable, given the existing professional knowledge, available analytical tools, and data limitations, but 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. The more critical error of the IMF, however, was its weak enforcement of fiscal conditionality, which admittedly was inadequate. The deficit targets involved only moderate adjustments, even when growth was higher than expected, while they were eased to accommodate growth shortfalls. Even though the annual deficit targets were missed every year from 1994, financing arrangements with Argentina were maintained by repeatedly granting waivers.

Structural reforms

The IMF correctly identified structural fiscal reforms, social security reform, labor market reform, and financial sector reform as essential to enhancing the medium-term viability of the convertibility regime, by promoting fiscal discipline, flexibility, and investment. These views were broadly shared by the authorities. In fact, most of the initiatives for reform in these areas came from the authorities; the role of the IMF was largely limited to providing technical assistance in the fiscal areas, particularly tax administration. Some gains were made in the early years, but the long-standing political obstacles to deeper reforms proved formidable. Little progress was made in later years, and the earlier reforms were even reversed in some cases.

The remarkable feature of the successive IMF-supported programs with Argentina was the paucity of formal structural conditionality. Despite the rhetoric about the importance of structural reforms in program documents, only two performance criteria (covering tax and social security reforms) were set in the first three IMF arrangements; in the subsequent arrangements, not a single performance criterion was set, though a number of structural benchmarks were included. Staff consistently expressed reservations over the weak structural content of the successive arrangements, but management, supported by the Executive Board, overruled the staff objections to approve programs with weak structural conditionality. As it turned out, the lack of strong structural conditionality had the unfortunate outcome of obliging the IMF to remain engaged with Argentina when the evident lack of substantive progress in structural reform should have called for an end to the program relationship.

Crisis Management, 2000–2001

In the fall of 2000, Argentina effectively lost access to voluntary sources of financing. The authori-

ties approached the IMF for a substantial augmentation of financial support under the Stand-By Arrangement approved in March 2000, which up to that time had been treated as precautionary. In response, from January to September 2001, the IMF made three decisions to provide exceptional financial support to Argentina, raising its total commitments to $22 billion. In December, however, the fifth review of the program was not completed, which marked the effective cutoff of IMF financial support.

The augmentation decision in January 2001

The decision to augment the existing arrangement, approved by the Executive Board in January 2001, was based on the diagnosis that Argentina faced primarily a liquidity crisis and that any exchange rate or debt sustainability problem was manageable with strong action on the fiscal and structural fronts. The protracted recession was thought to have resulted from a combination of adverse but temporary shocks, and it was assumed that external economic conditions would improve in 2001. The IMF was also well aware that the costs of a fundamental change in the policy framework would be very large and wished to give the authorities the benefit of the doubt, when they were evidently committed to making strong policy corrections. Exceptional IMF financing was thus deemed justified on catalytic grounds. Given the probabilistic nature of any such decision, the chosen strategy may well have proved successful if the assumptions had turned out to be correct (which they were not) and if the agreed program had been impeccably executed by the authorities (which it was not). The critical error was not so much with the decision itself as with the failure to have an exit strategy, including a contingency plan, in place, inasmuch as the strategy was known to be risky. No serious discussion of alternative strategies took place, as the authorities refused to engage in such discussions and the IMF did not insist.

The decisions to complete the third review in May and to further augment the arrangement in September 2001

While these decisions still involved uncertainty, the weak implementation of the program in early 2001 and the adoption—without consultation with the IMF—of a series of controversial and market-shaking measures by the authorities after March 2001 should have provided ample ground for concluding that the initial strategy had failed. In fact, even within the IMF, there was an increasing recognition that Argentina had an unsustainable debt profile, an unsustainable exchange rate peg, or both. Yet no alternative course of action was presented to the Board, and the decisions were made to continue disbursing funds to Argentina under the existing policy framework, on the basis of largely noneconomic considerations and in hopes of seeing a turnaround in market confidence and buying time until the external economic situation improved.

The decision not to complete the review in December 2001

After the September augmentation, economic activity and market confidence continued to collapse, making the achievement of the program's targets and the salvage of convertibility virtually impossible. While aware of this predicament, the IMF did not press the authorities for a fundamental change in the policy regime and announced in early December that the pending review under the Stand-By Arrangement could not be completed under the circumstances. Within a month of this announcement, economic, social, and political dislocation occurred simultaneously, leading to the resignation of the President, default on Argentina's sovereign debt, and the abandonment of convertibility, soon followed by government decisions that further amplified the costs of the collapse of convertibility. In those circumstances, the IMF was unable to provide much help and largely stood by as the crisis unraveled.

The decision-making process

The IMF's management of the Argentine crisis reveals several weaknesses in its decision-making process. First, contingency planning efforts by the staff were insufficient. Too much attention was given to determining—inconclusively—which alternative policy framework should be recommended to the authorities, while little effort was made to determine what practical steps the IMF should take if the chosen strategy failed. Second, from March 2001 on, the relationship between the IMF and the authorities became less cooperative, with the authorities taking multiple policy initiatives that the IMF viewed as misguided but felt compelled to endorse. Third, little attention was paid to the risks of giving the authorities the benefit of the doubt beyond the point where sustainability was clearly in question. Fourth, the Executive Board did not fully perform its oversight responsibility, exploring the potential trade-offs between alternative options. To some extent, this appears to have reflected the fact that some key decisions took place outside the Board and that some critical issues were judged by management to be too sensitive for open discussion in the full Board.

Lessons from the Argentine Crisis

The Argentine crisis yields a number of lessons for the IMF, some of which have already been learned and incorporated into revised policies and procedures. This evaluation suggests ten lessons, in the areas of surveillance and program design, crisis management, and the decision-making process.

Surveillance and program design

- **Lesson 1.** While the choice of exchange rate regime is one that belongs to country authorities, the IMF must exercise firm surveillance to ensure that the choice is consistent with other policies and constraints. Candid discussion of exchange rate policy, particularly when a fixed peg is involved, must become a routine exercise during IMF surveillance.
- **Lesson 2.** The level of sustainable debt for emerging market economies may be lower than had been thought, depending on a country's economic characteristics. The conduct of fiscal policy should therefore be sensitive not only to year-to-year fiscal imbalances, but also to the overall stock of public debt.
- **Lesson 3.** The authorities' decision to treat an arrangement as precautionary should not, but in practice may, involve a risk of weakened standards for IMF support. Weak program design and weak implementation in the context of arrangements being treated as precautionary do not help a country address its potential vulnerabilities. When there is no balance of payments need, it may be better not to agree to an arrangement, thus subjecting the country to market discipline rather than to program reviews by the IMF.
- **Lesson 4.** Emphasis on country ownership in IMF-supported programs can lead to an undesirable outcome, if ownership means misguided or excessively weak policies. The IMF should be prepared not to support strongly owned policies if it judges they are inadequate to generate a desired outcome, while providing the rationale and evidence behind such decisions.
- **Lesson 5.** Favorable macroeconomic performance, even if sustained over some period of time, can mask underlying institutional weaknesses that may become insuperable obstacles to any quick restoration of confidence, if growth is disrupted by unfavorable external developments. The IMF may have only a limited role to play when institutional weaknesses are deeply rooted in the political system, and structural conditionality cannot substitute for domestic ownership of the underlying reforms.

Crisis management

- **Lesson 6.** Decisions to support a given policy framework necessarily involve a probabilistic judgment, but it is important to make this judgment as rigorously as possible, and to have a fallback strategy in place from the outset in case some critical assumptions do not materialize.
- **Lesson 7.** The catalytic approach to the resolution of a capital account crisis works only under quite stringent conditions. When there are well-founded concerns over debt and exchange rate sustainability, it is unreasonable to expect a voluntary reversal of capital flows.
- **Lesson 8.** Financial engineering in the form of voluntary, market-based debt restructuring is costly and unlikely to improve debt sustainability if it is undertaken under crisis conditions and without a credible, comprehensive economic strategy. Only a form of debt restructuring that leads to a reduction of the net present value (NPV) of debt payments or, if the debt is believed to be sustainable, a large financing package by the official sector has a chance to reverse unfavorable debt dynamics.
- **Lesson 9.** Delaying the action required to resolve a crisis can significantly raise its eventual cost, as delayed action can inevitably lead to further output loss, additional capital flight, and erosion of asset quality in the banking system. To minimize the costs of any crisis, the IMF must take a proactive approach to crisis resolution, including providing financial support to a policy shift, which is bound to be costly regardless of when it is made.

The decision-making process

- **Lesson 10.** In order to minimize error and increase effectiveness, the IMF's decision-making process must be improved in terms of risk analysis, accountability, and predictability. A more rule-based decision-making procedure, with greater ex ante specification of the circumstances in which financial support will be available, may facilitate a faster resolution of a crisis, though the outcome may not always be optimum. Recent modifications to the exceptional access policy have already moved some way in this direction.

Recommendations

On the basis of these lessons, the evaluation offers six sets of recommendations to improve

the effectiveness of IMF policies and procedures, in the areas of crisis management, surveillance, program relationship, and the decision-making process.

Crisis management

- **Recommendation 1.** The IMF should have a contingency strategy from the outset of a crisis, including in particular "stop-loss rules"—that is, a set of criteria to determine if the initial strategy is working and to guide the decision on when a change in approach is needed.
- **Recommendation 2.** Where the sustainability of debt or the exchange rate is in question, the IMF should indicate that its support is conditional upon a meaningful shift in the country's policy while it remains actively engaged to foster such a shift. High priority should be given to defining the role of the IMF when a country seeking exceptional access has a solvency problem.

Surveillance

- **Recommendation 3.** Medium-term exchange rate and debt sustainability should form the core focus of IMF surveillance. To fulfill these objectives (which are already current policy), the IMF needs to improve tools for assessing the equilibrium real exchange rate that are more forward-looking and rely on a variety of criteria, examine debt profiles from the perspective of "debt intolerance," and take a longer-term perspective on vulnerabilities that could surface over the medium term.

Program relationship

- **Recommendation 4.** The IMF 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.
- **Recommendation 5.** Exceptional access should entail a presumption of close cooperation between the authorities and the IMF, and special incentives to forge such close collaboration should be adopted, including mandatory disclosure to the Board of any critical issue or information that the authorities refuse to discuss with (or disclose to) staff or management.

The decision-making process

- **Recommendation 6.** In order to strengthen the role of the Executive Board, procedures should be adopted to encourage: (i) effective Board oversight of decisions under management's purview; (ii) provision of candid and full information to the Board on all issues relevant to decision making; and (iii) open exchanges of views between management and the Board on all topics, including the most sensitive ones. These initiatives will be successful only insofar as IMF shareholders—especially the largest ones—collectively uphold the role of the Board as the prime locus of decision making in the IMF. While a number of approaches to modifying Board procedures to strengthen governance are possible, and the issue goes beyond the scope of the evaluation, some possible steps are discussed in the concluding section of Chapter 4.

CHAPTER

I Introduction

The Argentine crisis of 2000–02 was among the most severe of recent currency crises. The currency-board-like arrangement, under which the peso had been pegged at parity with the U.S. dollar since 1991, collapsed in January 2002 and, by the end of 2002, the peso was trading at Arg$3.4 to the U.S. dollar. Coming after three years of recession, the crisis had a devastating impact. The economy contracted by 11 percent in 2002, bringing the cumulative output decline since 1998 to nearly 20 percent. Unemployment rose to over 20 percent, and the incidence of poverty worsened dramatically.

The role played by the International Monetary Fund (IMF) deserves special attention for at least three reasons. First, unlike the cases of Indonesia and Korea, where the IMF had no program involvement for several years preceding the crisis, in Argentina the IMF had been almost continuously engaged through programs since 1991 (Box 1.1). Second, again unlike the other cases, the crisis in Argentina did not explode suddenly. Signs of possible problems were evident at least by 1999, which led the government to seek a new Stand-By Arrangement (SBA) with the IMF in early 2000. Third, IMF resources were provided in support of Argentina's fixed exchange rate regime, which had long been stated by the IMF as both essential to price stability and fundamentally viable. Indeed, in the debates on fixed versus flexible rates that followed the East Asian crisis, Argentina's currency-board-like regime was often held up as an example of the kind of credible fixed rate regime that is fundamentally viable.

This evaluation examines the role of the IMF in Argentina during 1991–2001, with a special focus on the period of crisis management from 2000 up to the first few days of 2002.[1] While the principal focus of the evaluation is on the crisis period, it is necessary to review experience in the preceding decade in order to shed light on why and how, despite its extensive involvement with the country, the IMF was not able to help Argentina prevent and better manage the crisis.

In keeping with the terms of reference of the Independent Evaluation Office (IEO), the primary purpose of the evaluation is to draw lessons for the IMF in its future operational work. The following qualifications apply:

(1) Any evaluation necessarily benefits from hindsight. While hindsight can be useful in drawing lessons for the future, in evaluating the past, and especially in determining accountability, it must be kept in mind that much of what we know now may not have been known to those who had to make the relevant decisions.

(2) The behavior of an economy is always subject to uncertainty, and uncertainties increase in crises. Decisions taken in the face of uncertainty cannot be judged to represent mistaken judgment ex ante just because they failed to achieve the results envisaged. It is necessary to take a probabilistic approach: were the ex ante probabilities of success high enough to justify the decision, given the expected benefit of success and the potential costs of an even more aggravated crisis if the strategy eventually failed?

(3) To be meaningful, evaluation of a particular strategy must imply comparison with an alternative that may have produced better results. However, it is extremely difficult rigorously to establish such a counterfactual.

(4) The IMF is only one of the actors involved. In practice, the country itself is ultimately responsible for its policy decisions. This is especially important when the underlying policy choices are strongly owned by the country—as they were in Argentina.

[1] The choice of this period leaves out issues related to the role of the IMF in Argentina's subsequent economic reconstruction and recovery. The IEO's terms of reference do not allow it to evaluate issues that have a direct bearing on the IMF's ongoing operations.

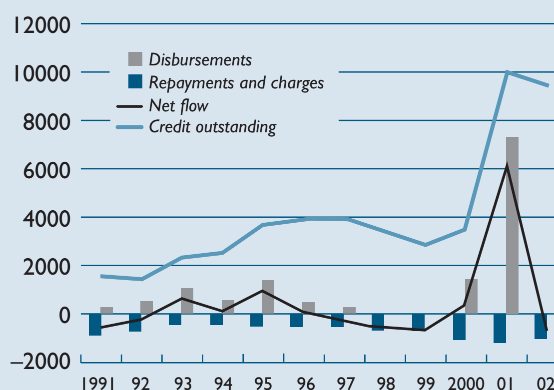
Box 1.1. The IMF and Argentina, 1991–2001

From 1991 through 2001, the IMF maintained five successive financing arrangements with Argentina. These included two extended arrangements under the Extended Fund Facility (EFF) approved in 1992 and 1998, and three SBAs approved in 1991, 1996, and 2000 (see Appendix 1 for details). Of these, the 1998 extended arrangement was treated as precautionary, and no drawings were made under it. As a result, the balance of outstanding IMF credit to Argentina actually declined during 1997–99. It was only in late 2000 that the IMF's exposure to Argentina rose sharply (see figure). In addition, the IMF provided extensive technical assistance to Argentina, dispatching some 50 missions during this period, mainly in the fiscal and banking areas, in order to support the objectives of the IMF-supported programs.

From early 2000 onward, the IMF-supported programs attempted to address the worsening recession as well as, from late 2000, Argentina's inability to access international capital markets. In March 2000, a three-year SBA for SDR 5.4 billion ($7.2 billion) was agreed to and, in January 2001, this was augmented by SDR 5.2 billion to SDR 10.6 billion ($13.7 billion). At the same time, additional financing was arranged from official and private sources. The total amount of financing was announced to be $39 billion, prompting the government to use the word "*blindaje*" (shield) in characterizing the package. In September 2001, the arrangement was further augmented by SDR 6.4 billion ($8 billion) to SDR 17 billion ($22 billion), with up to $3 billion set aside to be used in support of a possible debt-restructuring operation. In December 2001, with the hoped-for return of confidence nowhere to be seen and the fiscal program seriously off track, the scheduled program review was not completed, and IMF support of Argentina was effectively cut off.

Financial Transactions Between Argentina and the IMF

(In millions of SDRs)



Source: IMF database.

The evaluation makes extensive use of IMF documents made available to the IEO.[2] The IEO, however, is not given automatic access to documents that are purely internal to management or that cover management's exchanges with national authorities, except when such documents were shared with staff.[3] Since there is often close consultation between management and the IMF's major shareholder governments, and the records available to us do not cover these consultations, our judgments on certain policy matters are based on limited information. This is acknowledged where relevant.

The evaluation team has extensively interviewed a number of those involved in decision making in the IMF as well as some current and former officials of Argentina and other member countries. The team has also benefited from consulting with the extensive academic literature on the Argentine crisis and interacted with a number of individuals who have expressed views on the IMF's role in it.

The report is organized as follows. The rest of this chapter provides a brief overview of economic developments from 1991 to early 2002 and discusses factors that contributed to the crisis. Chapter 2 evaluates the content and effectiveness of surveillance and program design in the precrisis period, from 1991 to early 2000. The focus is placed on three areas of critical relevance to the IMF, namely (i) exchange rate policy, (ii) fiscal policy, and (iii) macro-critical structural reforms. Chapter 3 discusses major issues and procedures associated with the key decisions made by the IMF

[2]They include staff reports for Article IV consultations and use of IMF resources, technical assistance reports, briefing papers and back-to-office reports for staff missions and visits, internal memorandums and technical notes exchanged among staff or between staff and management, minutes or summaries of formal and informal Executive Board meetings, comments by management and staff on briefing papers, and policy papers prepared by staff for the Board. Some of these Board policy papers have been published, including on the IMF's website. Full citations for these papers are made in footnotes and not in the bibliography, except when they are available in print form.

[3]Management refers to the group of senior IMF officials consisting of the Managing Director, the First Deputy Managing Director, and two Deputy Managing Directors.

Table 1.1. Key Economic Indicators

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Real GDP growth (percent)	10.5	10.3	6.3	5.8	–2.8	5.5	8.1	3.8	–3.4	–0.8	–4.4	–10.9
Real private consumption growth (percent)	15.0	12.1	7.1	5.4	–4.0	7.3	8.7	2.5	–4.0	0.3	–4.9	–13.3
Real public consumption growth (percent)	–13.1	22.7	12.1	2.7	–1.6	–0.9	3.8	7.1	5.6	–0.1	–1.9	–13.5
Real fixed investment growth (percent)	31.5	33.5	16.0	13.7	–13.0	8.8	17.7	6.5	–12.6	–6.8	–15.7	–36.4
Inflation (CPI, Dec./Dec., percent)	84.0	17.5	7.4	3.9	1.6	0.1	0.3	0.7	–1.8	–0.7	–1.5	41.0
Money (M1, Dec./Dec., percent, in pesos)	148.6	49.0	33.0	8.2	1.6	14.6	12.8	0.0	1.6	–9.1	–20.1	78.4
Broad money (Dec./Dec., percent, in pesos)	167.9	63.0	55.9	14.9	–4.3	20.0	26.9	10.3	2.3	4.4	–19.7	18.3
Current account balance (billion U.S. dollars)	–0.4	–6.5	–8.0	–11.1	–5.2	–6.8	–12.2	–14.5	–11.9	–8.8	–4.5	9.6
(In percent of GDP)	–0.2	–2.9	–3.4	–4.3	–2.0	–2.5	–4.2	–4.9	–4.2	–3.1	–1.7	3.1
Export of goods and services (U.S. dollars, percent growth)	–2.1	3.4	8.5	17.8	28.9	13.6	9.0	0.7	–10.5	11.6	–0.5	–7.4
Import of goods and services (U.S. dollars, percent growth)	68.3	58.8	30.3	11.3	–4.6	15.8	24.1	3.4	–15.3	0.5	–16.6	–52.6
Public sector debt (percent of GDP)	34.8	28.3	30.6	33.7	36.7	39.1	37.7	40.9	47.6	50.9	62.2	. . .
External debt (percent of GDP)	34.5	27.7	30.5	33.3	38.4	40.6	42.7	47.5	51.2	51.6	52.2	42.9
Debt service ratio (percent)	33.6	27.5	30.9	25.2	30.2	39.4	50.0	57.6	75.4	70.8	66.3	. . .
International reserves minus gold (billion U.S. dollars)	6.2	10.2	14.0	14.6	14.5	18.3	22.3	24.8	26.3	25.1	14.6	10.5
Exchange rate (peso/U.S. dollar, end-period)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	3.4
Real effective exchange rate (end-period)[1]	140.5	165.4	177.8	169.3	162.9	163.3	175.8	170.6	177.6	184.8	184.7	71.6
Terms of trade (goods and services, percent change)	7.6	6.1	–7.7	14.4	–4.5	9.9	0.2	–5.1	–8.4	7.2	–5.7	–10.8
Central government primary balance (percent of GDP)	. . .	1.3	2.1	0.8	0.1	–0.5	0.4	0.9	0.4	1.0	0.1	0.7
General government primary balance (percent of GDP)	. . .	1.3	1.5	0.1	–1.3	–0.7	0.3	0.5	–0.8	0.5	–1.4	0.3
Central government overall balance (percent of GDP)	. . .	–0.2	0.9	–0.5	–1.5	–2.2	–1.6	–1.3	–2.5	–2.4	–3.8	–11.9
General government overall balance (percent of GDP)	. . .	–0.4	0.1	–1.4	–3.2	–2.9	–2.1	–2.1	–4.2	–3.6	–6.2	–12.8

Sources: IMF database; and World Bank, *Global Development Finance*.

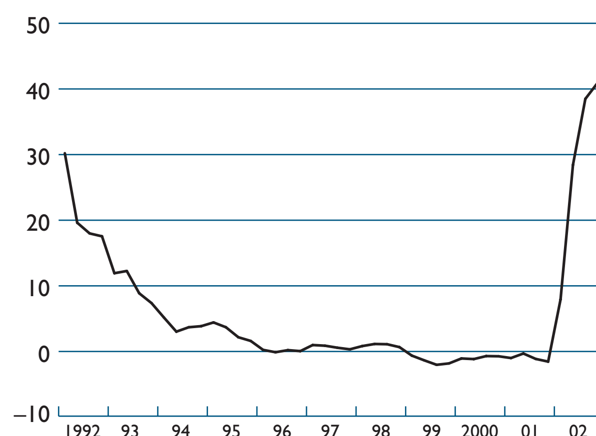
[1]Average of 1990 = 100.

during the crisis period, from late 2000 through the end of 2001. These decisions include (i) the completion of the second review and augmentation of the SBA (January 2001); (ii) the completion of the third review (May 2001); (iii) the completion of the fourth review and augmentation (September 2001); and (iv) the noncompletion of the fifth review (December 2001), which was effectively the cutoff of IMF financial support. Chapter 4 summarizes major findings of the evaluation, draws lessons for the IMF from the Argentine experience, and presents six sets of recommendations. Finally, ten accompanying appendixes provide more detailed information and analyses on some of the issues discussed in the report, including a timeline of major events and a list of interviewees.

Overview of Economic Developments, 1991–2001

The Convertibility Law, which pegged the Argentine currency to the U.S. dollar in April 1991, was a response to Argentina's dire economic situation at the beginning of the 1990s. Following more than a decade of high inflation and economic stagnation, and after several failed attempts to stabilize the economy, in late 1989 Argentina had fallen into hyperinflation and a virtual economic collapse (see Appendix 2). The new exchange rate regime, which operated like a currency board, was designed to stabilize the economy by establishing a hard nominal peg with credible assurances of nonreversibility. The new peso (set equal to 10,000 australes) was fixed at par with the U.S. dollar and autonomous money creation by the central bank was severely constrained, though less rigidly than in a classical currency board.[4] The exchange rate arrangement was part of a larger Convertibility Plan, which included a broader agenda of market-oriented structural reforms to promote efficiency and productivity in the economy. Various service sectors were deregulated, trade was liberalized, and anticompetitive price-fixing schemes were removed; privatization proceeded vigorously, notably in oil, power, and telecommunications, yielding large capital revenues.

Figure 1.1. Inflation[1]
(In percent)



Source: IMF, *International Financial Statistics*.
[1]Year-on-year change in CPI.

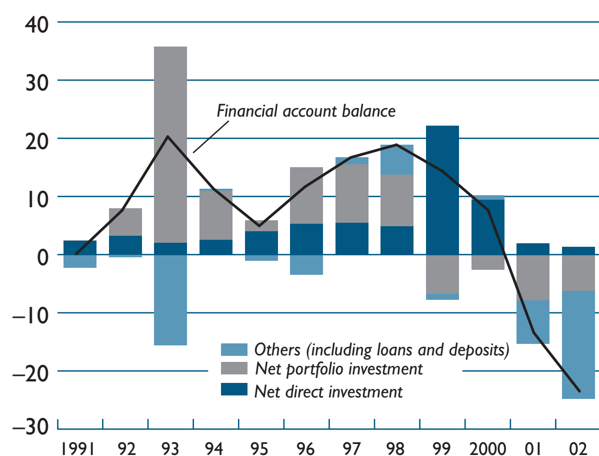
There was a marked improvement in Argentina's economic performance under the Convertibility Plan, particularly during its early years (Table 1.1). Inflation, which was raging at a monthly rate of 27 percent in February 1991, declined to 2.8 percent in May 1991; on an annual basis, inflation fell to single digits in the summer of 1993 and remained low (or even negative) from 1994 to the end of the convertibility regime in early 2002 (Figure 1.1). The overall fiscal balance of the federal government improved significantly from the previous years, with an average budgeted deficit of less than 1 percent of GDP during 1991–98.

Growth performance was impressive through early 1998, except for a brief setback in 1995 when Argentina was adversely affected by the Mexican crisis. For 1991–98, GDP growth averaged nearly 6 percent a year, vindicating the market-oriented reforms introduced in the early 1990s. Attracted by a more investment-friendly climate, there were large capital inflows in the form of portfolio and direct investments. During 1992–99, Argentina received more than $100 billion in *net* capital inflows, including over $60 billion in *gross* foreign direct investments (Figure 1.2).

The resilience of the convertibility regime was severely tested by the Mexican crisis in 1995. In response, Argentina launched a rigorous adjustment program under IMF financial support, consisting of strong fiscal action and structural reform. When the

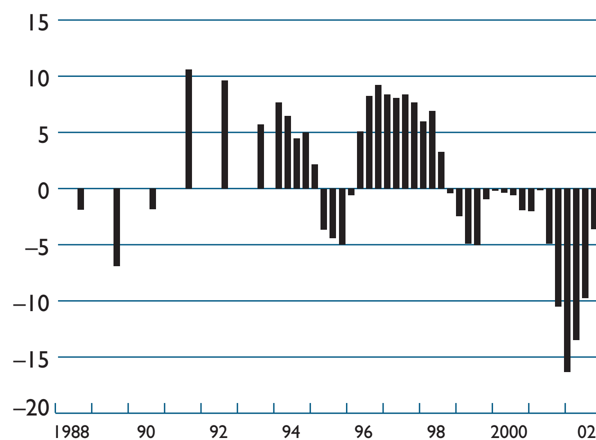
[4]The Convertibility Law was approved by Congress on March 27, 1991, establishing full convertibility of the austral at A10,000 per U.S. dollar (or the new peso created in January 1992 at Arg$1 per U.S. dollar), requiring the central bank in principle to back fully the monetary base with foreign exchange reserves, and prohibiting indexation of local-currency-denominated contracts. Unlike a "classical" currency board, however, the central bank was allowed to hold U.S. dollar-denominated domestic debt as a cover for part of base money, and was also not required to intervene to support the dollar (i.e., the peso technically could appreciate above parity). See, for example, Baliño and others (1997) and Hanke and Schuler (2002).

Figure 1.2. Capital Flows
(In billions of U.S. dollars)



Source: IMF, *International Financial Statistics.*

Figure 1.3. Real Quarterly GDP Growth[1]
(In percent)



Source: IMF, *International Financial Statistics.*
[1]Year-on-year.

peg survived and a V-shaped recovery ensued, this was widely interpreted as evidence of the convertibility regime's robustness and credibility. Favorable external circumstances also contributed to this outcome. This was a period in which the U.S. dollar was relatively weak, so the peg did not entail a loss of competitiveness, particularly given the improvements in productivity. Tariff reductions achieved under MERCOSUR also helped promote exports, particularly to Brazil, Argentina's largest trading partner. Capital flows to emerging markets were strong in the mid-1990s and Argentina was a major beneficiary. Argentina was relatively unaffected by the outbreak of the East Asian crisis in 1997; it quickly returned to the international capital markets in December of that year.

In October 1998, the performance of Argentina received the attention of the world when President Carlos Menem shared the podium of the Annual Meetings with the IMF Managing Director, who characterized "the experience of Argentina in recent years" as "exemplary." The Managing Director further remarked: "Argentina has a story to tell the world: a story which is about the importance of fiscal discipline, of structural change, and of monetary policy rigorously maintained."[5]

As it happened, Argentina's performance deteriorated from the second half of 1998, owing to adverse external shocks, including a reversal in capital flows to emerging markets following the Russian default in August 1998; weakening of demand in major trading partners, notably in Brazil; a fall in oil and other commodity prices; general strengthening of the U.S. dollar against the euro; and the 70 percent devaluation of the Brazilian real against the U.S. dollar in early 1999. Real GDP fell by over 3 percent in the second half of 1998. There was a mild pickup in economic activity in the second half of 1999, spurred by increased government spending in the run-up to the October presidential elections, but this was not sustained and GDP declined by 3½ percent for 1999 as a whole. The economy never recovered through the end of the convertibility regime (Figure 1.3).

The economic slowdown, coupled with the election-driven surge in public spending in 1999, had important implications for fiscal solvency. Argentina's consolidated fiscal balance had been in deficit throughout the 1990s except in 1993, but the magnitude was not large. Consolidated public sector debt, however, increased more rapidly because of the periodic recognition of off-budget liabilities, including the court-ordered payments of past pension benefits, which averaged over 2 percent of GDP a year during 1993–99. Even so, the rise in the debt-to-GDP ratio was modest as long as growth remained high, and there was even a small decline in the ratio

[5]Transcript of the press conference, October 1, 1998. A number of staff members interviewed told the evaluation team that they had considered such a sanguine assessment of Argentina to be not warranted in the fall of 1998.

from 1996 to 1997. The situation changed in 1999, when growth decelerated and the public finances deteriorated sharply. The debt-to-GDP ratio rose from 37.7 percent of GDP at end-1997 to 47.6 percent at end-1999, an increase of 10 percentage points in just two years. The ratio would eventually reach 62 percent at the end of 2001.

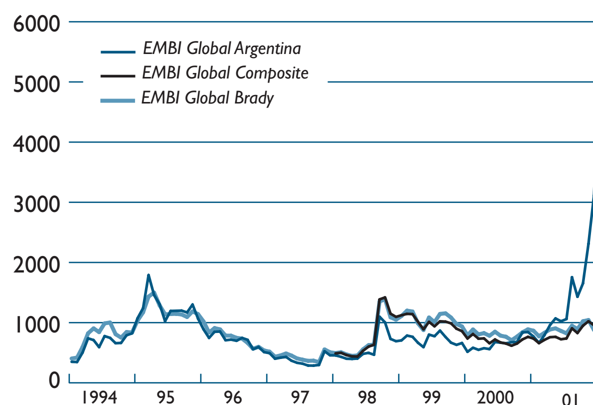
Argentina's problems intensified in 2000, when growing solvency concerns over the cumulative increase in public debt were exacerbated by the continued appreciation of the U.S. dollar and a further drying up of capital flows to emerging market economies. These developments would normally require a smaller current account deficit and a depreciation of the real exchange rate, but the convertibility regime placed severe limitations on the ability of Argentina to achieve this adjustment in a manner that could avoid recession. Argentina initially sought to restore market confidence by negotiating an SBA with the IMF, which it indicated would be treated as precautionary.[6]

Market confidence did not recover as expected and market access was effectively lost later in the year, leading Argentina to seek an augmentation of IMF support. From December 2000 to September 2001, the IMF made a series of decisions to provide exceptional financial support to Argentina, which ultimately amounted to SDR 17 billion, including the undrawn balance under the existing arrangement (see Box 1.1 for details). However, stabilization proved elusive. The augmentation announced in December 2000 and formally approved in January 2001 had a favorable effect, but it was short-lived. Pressure built up again as it became evident that political support for the agreed measures was lacking and program targets were unlikely to be met.

From the spring of 2001, the authorities took a series of measures in quick succession, including: an announced plan to change the anchor of the convertibility regime from the U.S. dollar to an equally weighted basket of the dollar and the euro (the switch to take effect only when the two currencies reached parity); a series of heterodox industrial or protectionist policies (called "competitiveness plans"), involving various tax-exemption measures in sectors most adversely affected by the recession; and an exchange of outstanding government bonds totaling $30 billion in face value for longer maturity instruments (the so-called mega-swap).[7] Many of these measures, which were taken without consultation with the IMF, were perceived by the markets as desperate or impractical, and served to damage market confidence.

Despite these initiatives and the financial support of the IMF, market access could not be restored, and spreads on Argentine bonds rose sharply in the third quarter of 2001 (Figure 1.4). Amid intensified capital flight and deposit runs, capital controls and a partial deposit freeze were introduced in December 2001. With Argentina failing to comply with the fiscal targets, the IMF indicated that it could not clear the disbursement scheduled for December. At the end of December, following the resignation of President Fernando De La Rúa, the country partially defaulted on its international obligations. In early January 2002, Argentina formally abandoned the convertibility regime and replaced it with a dual exchange rate system.

Figure 1.4. Interest Rate Spreads over U.S. Treasuries[1]
(In basis points)



Source: Datastream.
[1]JP Morgan Emerging Market Bond Index (EMBI)—Global Stripped Spreads.

[6]In IMF terminology, a financing arrangement is considered as "precautionary" if the authorities indicate an intention not to draw on the resources provided. However, there is no legal distinction between precautionary and regular arrangements, as the authorities have the right to use the resources made available under the arrangement, should circumstances change.

[7]Other measures included: (i) a transitional compensation mechanism (called the convergence factor) to mimic the basket peg through fiscal means, by paying exporters a subsidy and charging importers a duty equivalent to the difference between the prevailing exchange rate and the exchange rate calculated by the basket; and (ii) the zero deficit plan (which subsequently became law), mandating the government, in the event of a prospective deficit, to introduce across-the-board proportional cuts in primary expenditures, which revealed the dire liquidity position of the government and was generally perceived as impractical. See Box 3.3 for the chronology of these and other additional measures.

Factors Contributing to the Crisis

The causes of the Argentine crisis have been studied extensively, and a considerable literature has emerged on the subject (see, for example, Mussa, 2002; Hausman and Velasco, 2002; de la Torre and others, 2002; and Perry and Servén, 2002). The IMF also conducted its own internal review and drew a number of lessons from the crisis.[8] There is a general agreement that a combination of domestic and external factors contributed to the crisis, but different authors have emphasized different factors as relatively more important. Most have emphasized one or more of the following three factors as critically important: (i) weak fiscal policy (Mussa, 2002); (ii) the rigid exchange rate regime (Gonzales Fraga, 2002); and (iii) adverse external shocks (Calvo and others, 2002). Some have stressed a combination of these factors as critical (Feldstein, 2002; Krueger, 2002).[9]

It is difficult to isolate, from the many factors involved, those that were fundamentally more important. It is possible, however, to distinguish between the underlying factors that generated vulnerability and the immediate factors that triggered the crisis. In the absence of triggering events, a crisis may not have occurred when it did, but the underlying vulnerability would have continued and a crisis could have been triggered later by other adverse shocks. In the absence of the underlying vulnerability, however, the same adverse developments would not have had the catastrophic effects that were associated with the crisis, though they may well have produced some negative effects.

It is clear that Argentina's vulnerability arose from the inconsistency between the weakness of fiscal policy and its choice of the convertibility regime. The weak fiscal policy created serious liquidity problems for the government when market conditions tightened and led to the eruption of a funding crisis in early 2001. If Argentina's public sector had generated surpluses in its fiscal account during the precrisis years, it could have avoided the tightening liquidity constraints in 2000 and the all-out funding crisis of the public sector in 2001. Argentina also would have enjoyed greater flexibility in using fiscal policy to cope with the impact of adverse shocks, and would have been spared from the need to contract fiscal policy when output was already declining.

Underlying this poor fiscal performance were Argentina's weak political institutions, which persistently pushed the political system to commit more fiscal resources than it was capable of mobilizing. Public expenditure could not be controlled because spending was often used as an instrument of political favor. Tax administration was also weak, leading to widespread tax avoidance and evasion, and efforts to improve tax compliance were not successful. Further complicating fiscal management were certain features of Argentina's federal structure. The system of representation gave power to the provinces, which in turn relied on the federal government for much of their tax revenue. Provincial politicians enjoyed a large share of the political benefit of spending with little of the cost of taxation, creating poor incentives for fiscal responsibility. On the federal level, the revenue-sharing ("*coparticipation*") arrangements, under which the proceeds of some taxes (but not others) were shared with the provinces, led to highly distortionary tax policies (by creating incentives to use nonshared taxes, such as payroll and financial transactions taxes).[10] Under these circumstances, incentives to collect tax remained weak both in the provinces and at the federal level (Tommasi, 2002; Spiller and Tommasi, 2003).

Though extremely effective initially as a stabilization tool, the convertibility regime was a risky choice for Argentina over the medium term (Box 1.2). By all but eliminating money creation as a source of revenue, it raised the required level of fiscal discipline. While this was extremely positive in terms of its impact on inflation, it also increased the potential long-term disruptive effect if the fiscal discipline was not fully delivered. It also made adjustment to adverse shocks more difficult by eliminating nominal depreciation as an instrument of policy. Had wages and prices been sufficiently flexible downward, the required real exchange rate depreciation could have been achieved through price deflation. In

[8]Policy Development and Review Department, "Lessons from the Crisis in Argentina," SM/03/345, October 2003. Henceforth referred to as PDR (2003). See also Collyns and Kincaid (2003) for broader lessons on Latin America.

[9]There are studies that emphasize "structural" factors, such as economic liberalization and the volatility and procyclicality of international capital flows (Frenkel, 2003; Damill and Frenkel, 2003) and political factors (Corrales, 2002). As early as 1997, the insightful political analyses of Gibson (1997) and Starr (1997) predicted an eventual collapse of the convertibility regime based on political factors existing at that time. For a more complete list of studies on the Argentine crisis, see the bibliography.

[10]As another aspect of the *coparticipation* scheme, there was a tendency for excessive spending cuts to be made at the federal level when fiscal adjustment was required, because any effort to increase shared tax would lose a large share to the provinces. It was for this reason that Economy Minister José Luis Machinea in 1999 negotiated a temporary arrangement with the provinces, whereby the federal government would transfer a fixed amount to the provinces regardless of the amount of tax collected. See Cuevas (2003). Coming at a time of deepening recession, however, the fixed transfer scheme did not help the federal government improve its finances.

Box 1.2. Was the Convertibility Regime Viable?

Some authors have argued that the convertibility regime (a hard peg to the U.S. dollar) was fundamentally unviable and thus doomed to fail from the inception (Curia, 1999; and Gonzales Fraga, 2002). Issues related to a choice of exchange rate regime are complex. Here, we will only consider one aspect of the choice, namely, the ability of an exchange rate regime to accommodate shocks that require a change in the real exchange rate.

In considering the viability of the convertibility regime for Argentina, there are three relevant questions to ask:

- How frequent and large are required real exchange rate changes?
- How effectively can a required real exchange rate change be accommodated in the absence of nominal exchange rate flexibility?
- Assuming that the impact of a relevant shock is adverse and prolonged, how resilient is the economy against sustained deflation (when nominal flexibility is sufficient) or sustained output contraction (when insufficient)?

Several of Argentina's real characteristics were not ideal for supporting a peg to the U.S. dollar: (i) exports were predominantly homogeneous goods subject to frequent global shocks; (ii) Argentina's small total trade-to-GDP ratio (about 16 percent) required a large real exchange rate change to generate a given size of external adjustment; (iii) the U.S. share of trade was relatively small (about 15 percent); and (iv) Argentina and the United States did not share closely correlated business cycles. These were factors that could require frequent and possibly large real exchange rate changes, particularly with a fixed peg to the U.S. dollar, although there is no presumption that those changes would be necessarily large relative to the capacity of the country.

A country's ability to respond to a required change in the real exchange rate depends on the flexibility of its markets and institutions. In Argentina, at the inception of the convertibility regime, its institutional rigidities in the product and labor markets limited this ability. But these rigidities were an outcome of policy, and it was for this reason that a series of structural reforms were pursued in these areas in the early 1990s. Much rigidity remained, particularly in the labor market, but, given the magnitude and number of adverse shocks that hit Argentina in the late 1990s, it probably would have been unrealistic to expect that the country's nominal and real flexibility alone could deliver the required adjustment quickly.

Likewise, much of what makes up the resilience of an economy—such as financial sector soundness and fiscal discipline—is also policy-driven. In terms of financial sector soundness, Argentina had a strong banking system as measured by conventional prudential criteria, and the banking system did withstand the adverse impact of the crisis for some time. What weakened the resilience of the Argentine economy was the lack of fiscal discipline, in an environment where the public sector relied on external borrowing. If Argentina had persistently generated fiscal surpluses throughout the 1990s, the government would have retained capacity to finance the economy out of recession; if it had less external borrowing, the impact of the adverse shocks would have been less immediate. With a large real exchange rate shock, prolonged output contraction may have been unavoidable, but the country could have used its borrowing capacity to remain afloat until many of the shocks inevitably reversed themselves.

More fundamentally, the longer-term viability of any fixed exchange rate regime depends on the degree of political support—in this case, the understanding of the tough policies needed to keep the convertibility regime viable and the willingness to accept them.

the absence of downward wage flexibility, the improvement in the current account required by the series of adverse shocks that hit Argentina from late 1998 could only be achieved through a prolonged demand contraction.

Compounding these vulnerabilities was Argentina's limited market for domestic borrowing and its limited ability to issue long-term debt denominated in its own currency. As a result, the government relied heavily on external borrowing in foreign currencies. The combination of a weak fiscal policy and heavy reliance on external borrowing within the constraint of the convertibility regime became a recipe for disaster, when the country was hit by the prolonged adverse shocks. In particular, a sharp reduction, or "sudden stop" in the terminology of Calvo and others (2002), in global capital flows to emerging market economies increasingly raised the cost of external financing, and worsened the fiscal situation. Thanks to careful management of maturity structure, the impact of the sudden stop on the public sector's immediate financing need was not as great as it would have been had more of the debt been contracted at shorter maturities, but this only meant that the crisis took a few years to develop.

Political factors also played a prominent role in Argentina (Box 1.3). The new government of Fernando De La Rúa, who took office in December 1999 in the midst of growing signs of economic difficulties, was a coalition (*Alianza*) of the centrist Radical party and the center-left FREPASO party,

Box 1.3. The Politics of the Convertibility Regime

As with most major economic policy measures, the convertibility regime had important political dimensions, including:

- With the early success of the Convertibility Plan, President Carlos Menem, who had been elected to a six-year term, decided to seek a second term by changing the constitution. In January 1994, the two main political parties agreed on a framework for constitutional reform that would allow President Menem to serve a second term of four years, with the elections set for mid-1995. This led to political deals with opposition, provincial, and labor leaders, which weakened commitment to fiscal discipline and stalling—even rolling back in some cases—the pace of structural reforms. However, despite the pressure of the upcoming elections, the authorities were able to take decisive action on the fiscal and structural fronts in response to the Mexican crisis in early 1995.
- From early 1997, President Menem began to seek a third term, despite the constitutional injunction. His attempt was eventually not successful, but it created a prolonged period of political competition in which Peronist leaders at the federal and provincial levels tried to use public spending to win the nomination.
- Beset by bribery scandals, the Peronist party lost its majority in Congress after elections in October 1997. This made it difficult for the executive to secure congressional approval for its fiscal and structural policy agendas.
- In the presidential elections of 1999, the convertibility regime was so popular with the public that even the main opposition Radical party ran on the platform to maintain the fixed exchange rate regime. With the help of the FREPASO party, the Radical party won the elections and, on December 10, 1999, the new coalition (*Alianza*) government of Fernando De La Rúa took office, with José Luis Machinea as Minister of Economy.
- There was some—though marginal— opposition to the convertibility regime, because it was perceived as a symbol of the economic dislocation and unemployment that accompanied the radical deregulation, liberalization, and privatization initiatives of the early 1990s. Once the vulnerabilities of the convertibility regime had become apparent after late 1998, opposition became more vocal. During the presidential elections of 1999, some major candidates made remarks suggesting the need for a change in the convertibility regime, but they failed to receive broad public support.
- The *Alianza* turned out to be fragile. In October 2000, Vice President Carlos Álvarez resigned as a protest over lack of action by the Cabinet on alleged corruption charges. Lack of support within the coalition for strong fiscal adjustment led to the resignation of Minister Machinea on March 2, 2001 and that of his successor Ricardo López Murphy in the evening of March 19, the very day when he received public support from President De la Rúa and presented his economic agenda to the Annual Meetings of the Inter-American Development Bank (IDB) in Santiago.

which represented divergent views of priorities in economic policy. The *Alianz*a enjoyed a working majority in the Lower House of Congress, but the Senate and the majority of the provinces, including the three largest ones, remained under the control of the main Justicialist (Peronist) opposition. Internal differences within the government and its inability to receive broad support within the larger political establishment undermined the credibility of many government initiatives. The fragile state of the coalition, as well as the lack of broader political support, led to the resignation of Vice President Carlos Álvarez in October 2000 and the successive resignations of two Ministers of Economy (José Luis Machinea and Ricardo López Murphy) within 20 days in March 2001, with a devastating impact on market confidence at a critical stage. Political developments in the later months of 2001, including the defeat of the ruling coalition in congressional elections, also contributed to the perception that the government would not be able to take the very difficult steps needed to resolve the crisis.

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."

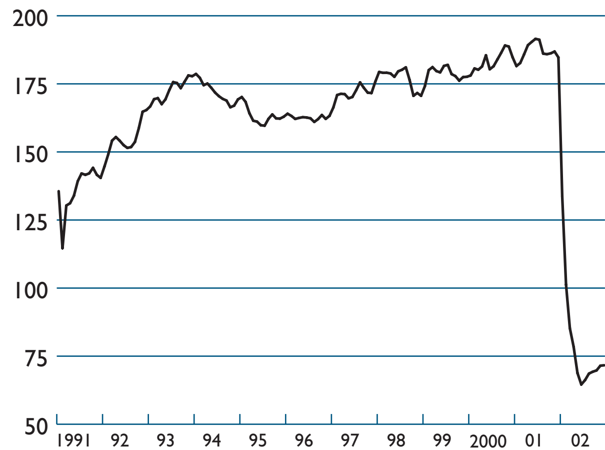
The staff was impressed by Argentina's ability to withstand the pressures that followed the Mexican crisis, and particularly the authorities' willingness to take tough measures in support of the peg.[1] These included a fiscal adjustment of some 2 percent of GDP (mostly through an increase in the value-added 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.

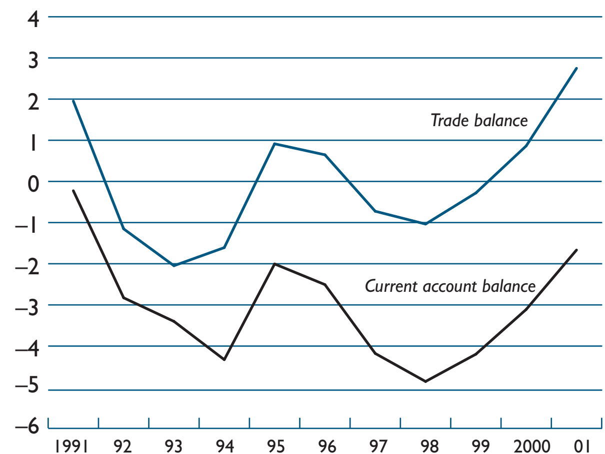
There were, however, some internal differences in perception. While IMF management and staff in the

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.

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.

Fiscal Policy

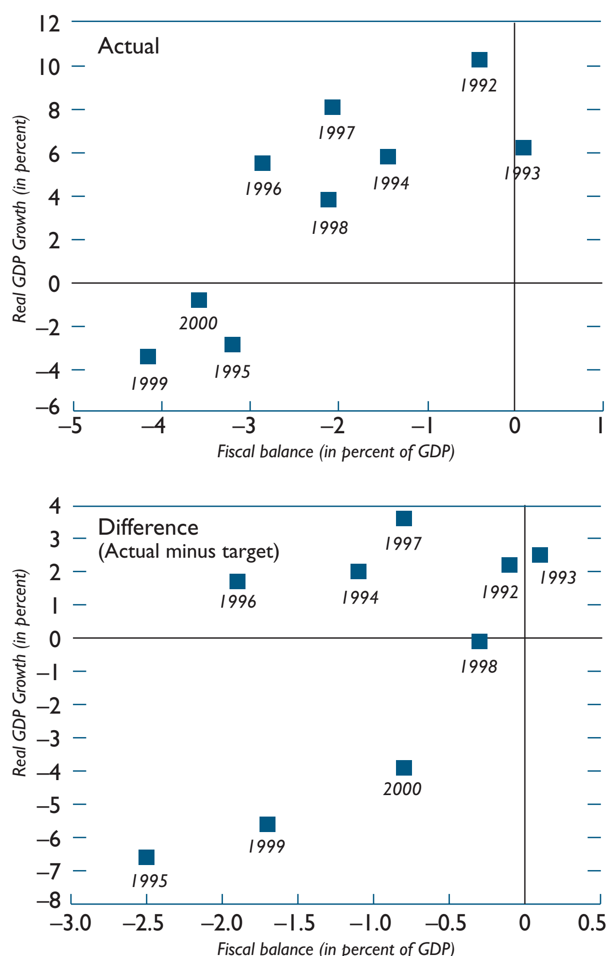
Fiscal policy was the single most prominent topic of discussion between the IMF and the Argentine authorities for virtually the entire period of convertibility. While fiscal policy often dominates the IMF's interactions with member countries, it assumed a particular importance in the case of Argentina. 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

[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.

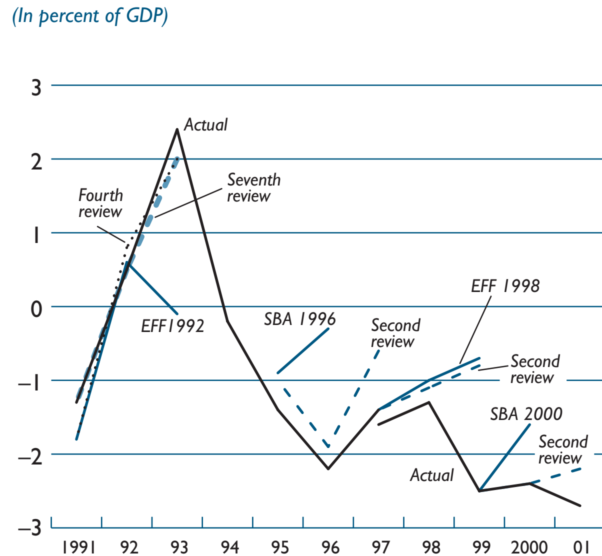
The focus on the deficit had two consequences. First, a failure to meet fiscal targets in a given year was followed merely by a renewed insistence that the authorities meet the flow targets for the follow-

[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

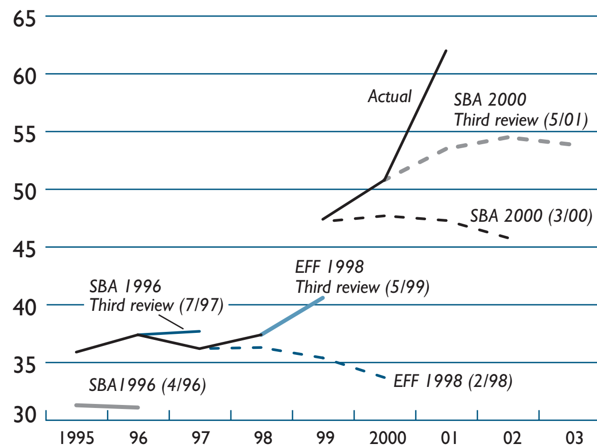
[14]For example, a briefing paper expressed concern over the fiscal pact negotiated between the federal and provincial governments in August 1993, in which the federal government took over a number of heavily indebted provincial pension systems and increased revenue transfers in exchange for the provinces' 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

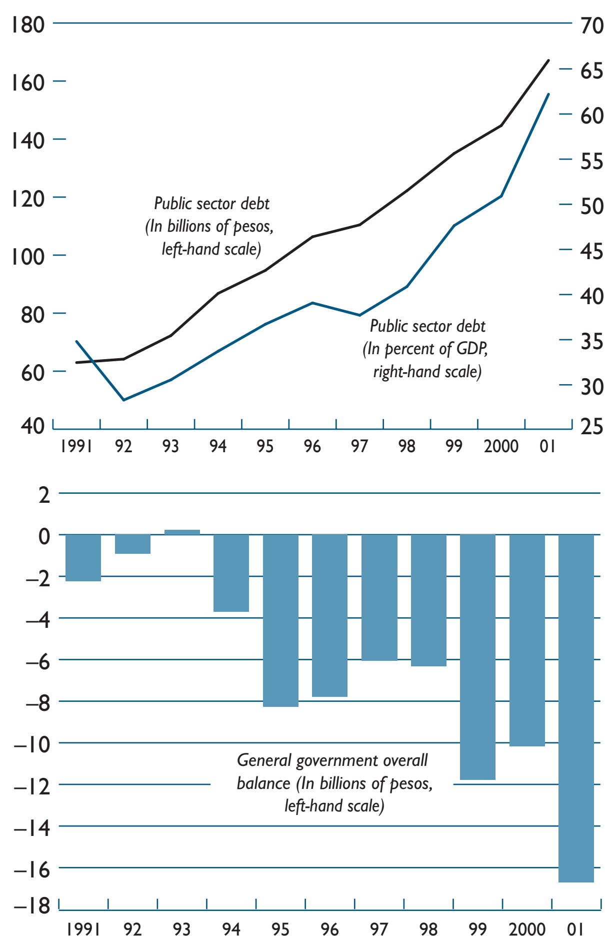
[15]The staff's analyses typically assumed relatively mild shocks, such as slower export growth or a rise in global interest rates. For example, the staff report of January 1998 forecast growth of 4 percent, followed by a gradual return to potential growth of 5 percent by 2000. The consolidated public 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

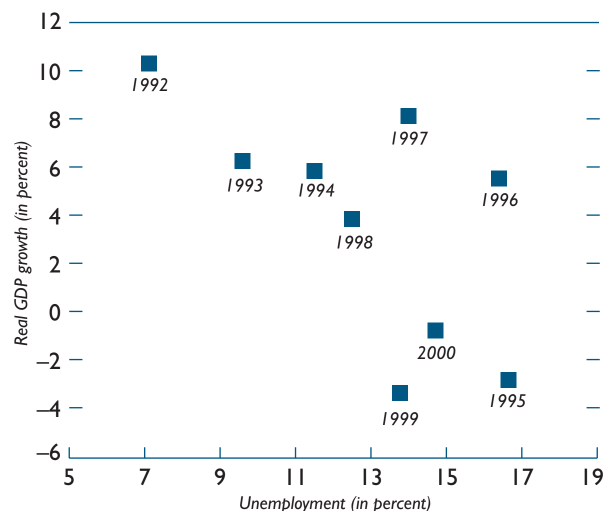
The IMF understood from the very beginning that structural fiscal reforms were critical for ensuring fiscal discipline and thereby contributing to the medium-term viability of the convertibility regime. It consistently raised the issue with the authorities and included some specific measures in successive 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]

[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.

Chapter 3
Crisis Management, 2000–01

This chapter presents an evaluation of the IMF's crisis management strategy from late 2000 through the collapse of convertibility during the first few days of 2002, focusing on issues and developments relevant at key decision points, namely: (i) the second review and augmentation of the March 2000 SBA in January 2001; (ii) the third review in May 2001; (iii) the fourth review and augmentation in September 2001; and (iv) the noncompletion of the fifth review in December 2001, which effectively cut off IMF financial support. It then examines separately the decision-making process, including the IMF's contingency planning efforts. For each of these decision points, we examine successively: program design and the case made in the staff report to the Board; additional elements considered by staff and management, but not conveyed formally to the Board; and the basis for the Board decision. We then appraise the decision made, focusing on whether the diagnosis was reasonable, given the facts known at the time, and whether the decisions made were consistent with that diagnosis.

Second Review and Augmentation, January 2001

Background

In early 2000, the new Argentine government negotiated a three-year SBA to replace the extended arrangement that had fallen off track. The new arrangement, approved in March, provided SDR 5.4 billion ($7.2 billion) and was aimed at buttressing investor confidence and facilitating a sustainable recovery of the economy. The program design emphasized tax and expenditure measures to stem a further deterioration of the fiscal balance and renewed efforts at structural reform, on the basis of which confidence would be boosted, contributing to lower costs of financing for Argentine borrowers. The recession was believed to have bottomed out and, with the projected more favorable external environment, GDP growth in 2000 was expected to rebound to 3.4 percent. External financing requirements, although large, were expected to remain manageable if the program was fully implemented. For these reasons, the authorities announced their intention to treat the arrangement as precautionary.

In the event, the expected recovery failed to materialize, program implementation wavered, and the coalition government visibly weakened with the resignation of Vice President Carlos Álvarez in early October. Amid these unfavorable economic and political developments, Argentina effectively lost access to international capital markets. Although the arrangement had been treated as precautionary up to this time, the authorities recognized the gravity of the situation and requested exceptional support from the IMF. Unlike other major economies in the region, which had slowed in the aftermath of the 1997–99 emerging market crises but had then begun to recover, Argentina had remained trapped in recession for two years; the overall fiscal deficit was projected to reach 3.6 percent of GDP for 2000, with the public debt-to-GDP ratio rising to nearly 50 percent.

At this time, two diagnoses were possible regarding Argentina's protracted recession and loss of market access. One was to view them primarily as a liquidity crisis resulting from adverse but temporary shocks. According to this interpretation, growth could return shortly, if some confidence-enhancing policy adjustments were implemented, including appropriate fiscal adjustment and measures to improve competitiveness, but no fundamental changes were needed in the exchange rate regime or the structure of debt. In support of this view, a tentative recovery in competitiveness did appear to be under way. Reflecting strong growth in global commodity prices, Argentina's terms of trade had experienced a sharp rebound in 2000, after a steady decline over 1997–99, and there was a shift in the trade balance from a deficit to a modest surplus in 2000. The banking system remained well capitalized, with high levels of liquidity.

An alternative diagnosis would have been to view the slowdown in economic activity as resulting from an exchange rate that had become significantly overvalued because of a series of adverse shocks. According to this interpretation, adjustment would call for

either a nominal devaluation or a substantial price deflation, each with adverse implications for (public and external) debt sustainability. Indeed, Argentina's external debt was then projected to reach 488 percent of exports at end-2000, with total external debt service (excluding the rollover of short-term debt) amounting to 94 percent of export receipts. While the public debt-to-GDP ratio, at just under 50 percent at end-2000, did not appear particularly large, most of it was dollar-denominated, which implied that if the peso were indeed devalued to reflect its real equilibrium level, the debt-to-GDP ratio would shoot up to levels where sustainability would come into question, if this were not already the case.

The appropriate response to Argentina's request for IMF support depended critically on which diagnosis was correct. If the country were indeed facing a liquidity crisis, and had good prospects for regaining market access on appropriate terms in the near future, the provision of large IMF financing, combined with some adjustment, was warranted on catalytic grounds. On the other hand, if there were a large misalignment of the real exchange rate or if the debt were unsustainable, the IMF should not provide large access without requiring a fundamental change in the policy regime, possibly involving devaluation, debt restructuring, or most likely both.[1]

The IMF adopted the liquidity crisis view of Argentina's loss of market access.[2] Its response therefore involved the following elements: (i) agreeing with the authorities on a strengthened program emphasizing growth, competitiveness, and medium-term fiscal discipline; (ii) allowing them to purchase the undrawn amount under the SBA immediately; and (iii) more than doubling the access under the existing SBA to SDR 10.6 billion (500 percent of quota), equivalent to about $13.7 billion. In combination with commitments of other IFIs and the Government of Spain, and with financing assurances from the private sector, the total headline figure of the "*blindaje*" was advertised to be almost $40 billion.[3]

The key elements of this response were negotiated between IMF staff and the Argentine authorities from September to the first half of December 2000, with periodic involvement of the Board.[4] The package was announced to the public in substantial detail on December 18, 2000 and was soon followed by the disbursement of the undrawn amount of $2 billion accumulated during the first nine months of the arrangement. This paved the way for a marked easing of market conditions by the time the augmentation was formally approved by the Board on January 12, 2001.

Program design and strategy

The program was based on the diagnosis that sustainability of both the public debt and the current account was achievable, with sufficient policy adjustments within the existing regime. In particular, the staff report noted that Argentina's competitiveness had been improving quickly in recent months, a trend that was expected to continue. It was also argued that a collapse of the convertibility regime, as well as a debt default, would have tremendous adverse implications for Argentina and also for emerging markets as a whole. The exchange rate peg still appeared to enjoy strong and broad support within Argentina, making any move against it politically unthinkable. The main risk to the program was seen to come from weak implementation.

The main features of program design were: (i) a small relaxation of the fiscal deficit and debt targets, so as to limit the contractionary impulse of fiscal policy, while preserving the objective of stabilizing public debt dynamics in the near term (Table 3.1);[5] and (ii) acceleration of structural reforms deemed critical both to ensure long-run fiscal sustainability and to strengthen competitiveness, in particular fiscal, social security, and health care reforms and other measures aimed at promoting investment. The program assumed that these measures, if vigorously

[1]Board decisions governing the use of IMF resources mandate that financing not be provided in support of unsustainable policies. Decisions related to the Supplemental Reserve Facility (which is intended to be the principal instrument of large access in a capital account crisis) state: "The Fund will be prepared to provide financial assistance . . . to a member that is experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence . . . *if there is a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result, within a short period of time, in an early correction of these difficulties*" (emphasis added). They further note that "this facility is likely to be utilized in cases where the magnitude of outflows may create a risk of contagion that could pose a potential threat to the international monetary system." See *Selected Decisions and Selected Documents of the International Monetary Fund*, 2002, pp. 325–26.

[2]Management used the expressions "a liquidity need" and "a rollover problem" in describing Argentina's difficulty to the Executive Board in November.

[3]The sum included the loan commitments of $2.4 billion each over the next two years from the World Bank and the IDB. The $2.4 billion from the World Bank, however, did not represent new money but the loans already committed.

[4]Informal Board meetings were convened on October 30, November 11, and December 18, 2000. IMF management maintained close and frequent contact with G-7 treasuries and finance ministries during this period.

[5]The program endorsed the actions already taken by the authorities in November, including the relaxation of the federal deficit target for 2001 to $6.5 billion from $4.1 billion and the extension of the target year for eliminating the deficit under the Fiscal Responsibility Law from 2003 to 2005.

Table 3.1. Program Projections and Targets for 2001

	2000 Outcome	2001 Projections					2001 Outcome
		March 2000	September 2000	January 2001	May 2001	September 2001	
Real GDP growth (in percent)	–0.8	3.7	3.7	2.5	2.0	–1.4	–4.4
Real investment growth (in percent)	–6.8	. . .	. . .	5.8	–0.3	–7.7	–15.7
Terms of trade change (year on year, in percent)	. . .	–0.2	1.0	0.5	–0.6	–0.6	–0.6
REER appreciation (+)							
(12-month basis, in percent)[1]	1.6	. . .	. . .	. . .	1.4	8.6[2]	2.9
Export growth							
(In terms of U.S. dollars, in percent)	13.3	10.6	11.2	9.1	7.6	3.7	0.8
(Volume, in percent)	2.7	10.0	9.0	7.2	7.4	4.8	4.6
External balance (in billions of U.S. dollars)							
Current account balance	–8.8	–14.5	–11.0	–9.8	–10.0	–8.2	–4.3
Capital account balance	7.7	. . .	13.3	6.0	3.5	–5.7	–15.1
Nonfinancial public sector	. . .	. . .	3.9	0.0	–1.4	–2.6	. . .
Nonfinancial private sector	. . .	. . .	9.0	5.2	3.9	–4.0	. . .
Financial system	. . .	. . .	0.8	0.4	0.7	1.4	. . .
Consolidated public sector fiscal balance[3]							
Revenues (in percent of GDP)	24.6	. . .	. . .	24.7	25.0	24.7	23.7
(In billions of pesos)	70			73	73	69	64
Noninterest expenditures							
(In percent of GDP)	24.2	. . .	. . .	23.1	23.4	23.2	25.0
(In billions of pesos)	69			68	68	65	67
Primary balance (in percent of GDP)	0.5	. . .	2.4	1.5	1.6	1.5	–1.4
Overall balance (in percent of GDP)	–3.6	. . .	–2.0	–3.1	–3.2	–3.7	–6.2
Public sector debt							
(In percent of GDP)	50.9	47.3	49.6	52.5	53.5	56.9	62.2
(In billions of U.S. dollars)	145			154	157	160	167
Memorandum item:[4]							
Nominal private investment growth (in percent)	–8.1	6.6	9.1	. . .	2.4	–9.8	–18.1

Source: IMF staff reports.
[1]Based on 1996 trade weights.
[2]Actual through September 2001.
[3]Including the indexation of government bonds and interest capitalization associated with the debt exchange in 2001 and excluding bonds issued to banks in connection with the banking crisis, and the reinstatement of wage and pension cuts implemented in July 2001.
[4]World Economic Outlook projections made in May 2000, October 2000, May 2001, and October 2001.

implemented, would bring about a virtuous circle of improved confidence, resumption of growth, and improved prospects for public and external debt sustainability. GDP growth, which was –0.8 percent in 2000 and had been projected to rebound to 3.7 percent in 2001, was scaled down to a projected 2.5 percent. Real investment was expected to grow by 5.8 percent, following a decline of 6.8 percent in 2000. The program envisaged export growth of 11 percent over the medium term, and a general continuation of the improvement in the external environment, including a further decline in U.S. interest rates, further depreciation of the U.S. dollar, and further improvements in the country's terms of trade.

The critical issue related to the recovery of confidence. The official financing provided did not cover the full financing needs of the coming year. The strategy therefore relied on the catalytic role of IMF financing, assuming a quick recovery of market confidence and a resumption of private capital inflows.[6] This imposed a "market test" of the program's effectiveness: if market access could not be

[6]Official financing is considered catalytic if it is sufficiently large to build confidence, but not large enough to cover all projected outflows. For a recent study of the effectiveness of catalytic official finance, see Cottarelli and Giannini (2002).

restored soon (effectively by the end of the first quarter), it would be a sign that the program was not working.[7] The financing provided was front-loaded, with 106 percent of quota disbursed immediately and three more installments of 46 percent of quota disbursed over the remaining quarters of 2001. A controversial aspect was the proposal to provide only one-fifth of total access under the Supplemental Reserve Facility (SRF), which involves a higher rate of charge and a shorter repayment period than under an SBA, and to invoke exceptional circumstances to provide the rest under conventional SBA terms.[8]

The program's policy emphasis remained on fiscal adjustment, with five out of six performance criteria targeting fiscal variables (see Appendix 4 for details). One of the performance criteria and an indicative target were included specifically to monitor the provincial finances. In addition, there were two prior actions requiring the authorities to rescind by decree the actions of Congress that had added unwanted items in the 2001 budget and deadlocked the passage of legislation to reform the pension and health care systems.[9] Structural reforms, although presented as critical to the success of the program, were subject only to benchmarks.

In the report accompanying the request, the staff characterized the risks faced by the program as "significant," emphasizing developments in the external environment and the degree of support provided by the political class to the government's strategy. However, an alternative scenario presented in a supplemental note right before the Board meeting, reflecting the revised World Economic Outlook (WEO) projections, was more optimistic than the baseline of the staff report. This suggested that, in the staff's view, the baseline was essentially conservative and actual risks were probably lower.

Additional considerations

The staff's analytical efforts focused on how to restart growth, which was viewed as critical for debt sustainability. However, the staff also recognized that there was little that structural reforms could achieve in terms of improving the supply side of the economy in the short run. It was primarily in this context that the staff examined possible alternative strategies. The staff analysis, as of October 2000, indicated that (i) given the high degree of dollarization of the economy, a shift to a floating exchange rate regime would likely be very disruptive, at least in the initial phase, unless it were possible substantially to contain the initial overshooting of the currency; (ii) dollarization at par would likely have modest benefits as well as relatively modest costs; and (iii) dollarization at a more depreciated rate could help improve competitiveness and moderate the initial effects of the devaluation, but it was uncertain whether it would be credible and therefore sustainable. In presenting the analysis of these issues, the staff did not state either the overvaluation of the exchange rate or debt sustainability as the fundamental problem.

Comments offered by review departments on the briefing paper for the negotiating mission in mid-November generally expressed concerns on several points, including: (i) the limited credibility of the government's commitment to fiscal consolidation when the effort was effectively being pushed back in time; (ii) the crowding out of private investment implied by the financing plan, which relied heavily on domestic sources of finance (Box 3.1); and (iii) the possibility that market access could not be restored as quickly as necessary. It is noteworthy that RES, which was then in charge of monitoring international capital markets, even suggested that it was time to start working on a comprehensive debt restructuring. Much the same level of concern was expressed internally by reviewing departments when the program design was finalized.

The Board decision

Several issues were raised at the informal meeting convened in late December by the Managing Director to inform the Board of his recommendation. Some Directors urged the staff to explore alternative solutions, including modifying the exchange rate regime and restructuring debt. Executive Directors indicated that they would have preferred a blend of resources with a larger SRF component, and a few Directors also pointed out the need for the IMF to have an exit strategy. In response, the Managing Director indicated that (i) the staff had been asked to produce two scenarios, with and without the "currency board" and had concluded that the risks in-

[7]Programmed financing requirements for the first two quarters exceeded identified (official and domestic) financing sources by $703 million and $1,726 million, respectively. The $2 billion balance accumulated under the SBA meant that Argentina could afford to delay new placements in international capital markets until after the end of the first quarter. In effect, the program assumed new placements of $500 million in the first quarter and $2 billion in the second quarter.

[8]Access under an SBA is normally capped at 300 percent of quota. It was argued that Argentina faced both a short-term balance of payments need (which the SRF was meant to address) and a medium-term one, as was clear from the large humps in debt amortization in 2002 and 2003 that a larger recourse to the SRF would have implied.

[9]These prior actions were not explicitly spelled out in the program documents, although there were clear understandings between the IMF staff and the authorities.

Box 3.1. Framework and Implementation of Private Sector Involvement

Following the series of capital account crises in the late 1990s, the international community intensified its efforts to agree on a framework for involving the private sector in crisis resolution. The IMF's International Monetary and Financial Committee (IMFC), in its September 2000 meetings held in Prague, outlined a framework for taking due account of PSI when making IMF financing available.

The IMFC communiqué read in part: "In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly. . . . Reliance on the catalytic approach at high levels of access presumes substantial justification, both in terms of its effectiveness and the risks of alternative approaches. In other cases, emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems. In yet other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, might be warranted to provide for an adequately financed program and a viable medium-term payments profile."

At the time the *blindaje* was being discussed, implementation of the "Prague Framework" was an important consideration and, in the absence of proven modalities, the announcement by the Argentine authorities that they had secured significant commitments from the private sector was taken as a sign that the new approach—based on the provision of incentives to encourage countries to take strong steps at the early stages of their financial difficulties to prevent a deepening crisis—was working. It appeared to be a concrete implementation of the first ladders of the "tool kit" defined by G-7 Finance Ministers at the Köln summit, and broadly endorsed by the IMF, namely "linking the provision of official support to efforts by the country to seek voluntary commitments of support and/or to commit to raise new funds from private markets" and/or "to seek specific commitments by private creditors to maintain exposure levels."

Specifically, the private sector component of the *blindaje*—about $20 billion over the next five years—involved an agreement with the 12 market-making institutions in Argentina to roll over maturing bonds and to purchase new public issues for $10 billion, understandings with private pension funds to purchase new public issues for $3 billion, and liability management operations on international bonds for $7 billion. Because these agreements were premised on the transactions being conducted at market prices, they represented only loose commitments. As the table below indicates, financing projections for 2001, made at different times throughout the year, assumed a disproportionate reliance on domestic (and largely captive) creditors rather than on the international private sector.

Projected Federal Government Financing, 2001

(In billions of U.S. dollars)

	January	May	August	December
Official creditors	9.7	9.6	10.2[1]	10.2
Resident bondholders	8.2	11.8	9.3	15.8[2]
Nonresident bondholders	3.9	0.5	0.8	0.8
Total	21.8	21.9	20.3	26.8

Source: IMF staff reports.

[1]Excludes $4 billion in purchases from the IMF to be retained in central bank reserves.

[2]Includes unidentified sources, broadly covering the "captive" market.

volved in modifying the exchange rate regime were overwhelmingly larger; and (ii) he was thinking about an exit strategy for the IMF, but preferred not to discuss it in that setting.

On January 12, 2001, the Executive Board unanimously approved management's recommendation to support the authorities' request. The statements made by Directors at the meeting, however, indicated that there were in fact three distinct groups:

- A small group was of the view that the program contained all the ingredients of success and would get Argentina out of trouble soon.
- At the other extreme, a small minority of industrial country chairs (including the representatives of two G-7 countries) articulated the view that, under realistic assumptions, the debt dynamics were unsustainable and therefore the program was very unlikely to succeed. They were nevertheless willing to give it the benefit of the doubt, based on three considerations: (i) the theoretical possibility that a return of confidence, brought about by determined implementation of the program, would make the staff's baseline scenario come true; (ii) the perception (in part influenced by the staff's generally positive surveillance assessments) that Argentina had built a stellar track record over the 1990s and therefore deserved to be given a chance; and (iii) the large costs of failing to support the country at this juncture.
- In between, a large group saw substantial risks in the program and was unconvinced that it provided a durable solution. This group considered that the program was built on excessively opti-

mistic GDP and export growth assumptions and furthermore that the two objectives of the program (restarting growth to stabilize the public debt dynamics and ensuring external sustainability) were potentially inconsistent. Nevertheless, the program was thought to present the best alternative, provided that it was used by the Argentine political system as a window of opportunity to tackle the needed fiscal adjustment and structural reforms. They were impressed by the amount of private sector involvement (PSI)—an important consideration in view of the International Monetary and Financial Committee's (IMFC) communiqué issued in September 2000—although the nature of the commitments secured by the authorities was not clear (see Box 3.1).

Concern about the viability of the program and the uncertainties associated with it was reflected in the fact that some Directors called on the staff to work out contingency measures and alternative solutions, including a change in the exchange rate regime and a restructuring of debt. Most, however, only indicated the need for close monitoring, without specifying what should be done in case monitoring revealed difficulties. Many considered that the extent and nature of PSI effectively achieved, as well as the price at which it could be obtained, would be the litmus test of the program's success. All Directors emphasized that the key to success was a return of confidence, which could only be brought about by strict adherence to the program; this would in turn require full support from the whole spectrum of Argentine society, including Congress, provincial officials, the bureaucracy, and labor unions. While the behavior of the political establishment on key elements of the program in the last months of 2000 did not bode well in this connection, Directors were impressed by the determination of the authorities (as demonstrated among others by their compliance with the prior actions) and were also mindful of the cohesion and decisiveness with which the country had reacted at the time of the Mexican crisis in 1995.

Overall assessment

It can be argued that *from late 2000 to early 2001 there were several compelling reasons to support Argentina:*

- Argentina had not drawn on the resources made available under successive IMF arrangements over the previous three years. This meant that the country was effectively coming to the IMF for financial assistance for the first time in a long while and that the IMF's exposure to Argentina was relatively low.
- The decisiveness with which the country's establishment had dealt with the Mexican crisis offered hope that a similarly strong response was possible on this occasion and provided legitimate grounds for giving Argentina the benefit of the doubt.[10]
- There were genuine concerns about contagion from an all-out crisis in Argentina at the time, when there was nervousness elsewhere in the world, including in Turkey and Brazil. There was also a more specific concern that other countries with currency boards might come under pressure if a crisis in Argentina revealed that such exchange rate regimes were not crisis-proof.
- The increase in the IMF's exposure to Argentina tied to this review was large (about $2.8 billion) but it left ample room for further support in case of need.
- The cost of any alternative strategy (for example, abandoning the peg) was certain to be large.

Program design was highly optimistic. If the key assumptions made under the program about exogenous factors had materialized and the agreed policy measures had been implemented, the strategy may well have succeeded in creating breathing space for Argentina, if not in providing a permanent solution.[11] However, the assumptions were overly optimistic, given what the staff and the Board knew at the time and relative to the market's "consensus" forecast (Figure 3.1). In addition, the program suffered from the following shortcomings:

- Sensitivity analysis failed to explore the impact of significantly less favorable external conditions and policy slippages, in particular on debt sustainability. In addition, no serious analysis of exchange rate sustainability was made.[12]

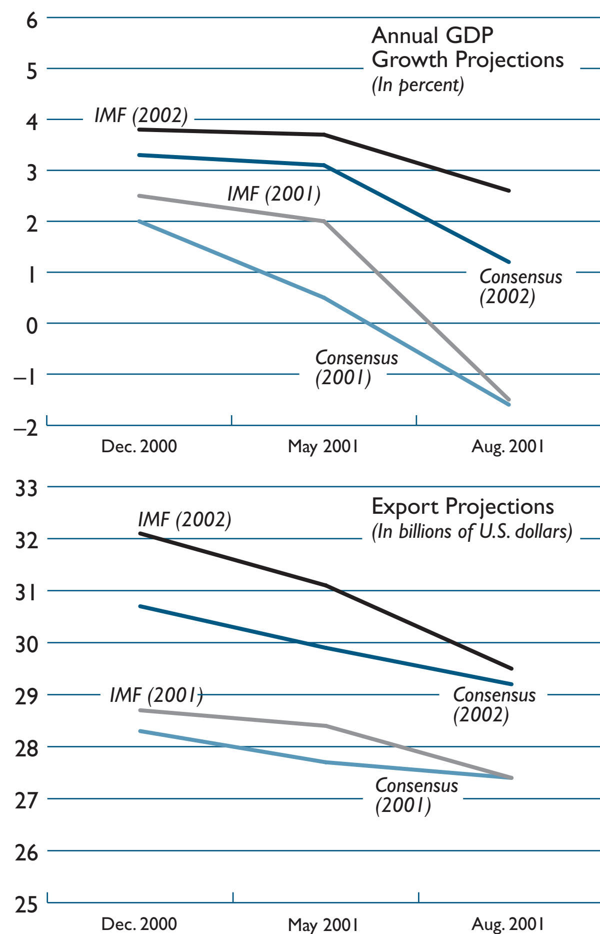
[10]Based on extensive exchanges with political experts, the evaluation team is of the view that the political situation in late 2000 was much more divisive than in 1995, and that to think that the same decisiveness could be repeated misunderstood Argentine politics.

[11]In the event, at least three critical assumptions turned out to be incorrect. First, the political system proved unable to deliver the required fiscal adjustment. Second, the terms of trade fell slightly instead of retaining the upward trend of 2000. Third, the peso appreciated further in real effective terms, driven by the rise of the U.S. dollar against the euro and the weakening of the Brazilian real. As a result, exports grew by 0.9 percent instead of the large increase of 9 percent that was assumed. U.S. interest rates did decline, but Argentina benefited from this only temporarily, as confidence failed to recover, leading to a further output decline instead of the expected pickup.

[12]Sensitivity analysis in the staff report examined both public debt sustainability and external sector dynamics, but each sce-

- There was an inconsistency in the program, as noted by some Executive Directors. Even with the rather optimistic assumptions made in the WEO projections, the IMF's standard template of external debt sustainability analysis, if available in late 2000, would have indicated that Argentina needed to generate a noninterest current account surplus of 0.5 percent of GDP in 2001 in order to stabilize the external debt to GDP ratio at over 50 percent of GDP. This was inconsistent with the large projected current account deficit (see Appendix 6).
- Although the restoration of fiscal stability was a key objective, program design in practice amounted to easing fiscal policy in the short run while affirming the commitment to fiscal discipline over the medium term. This was a continuation of the policies that had already been pursued by the authorities and had proved to have failed in restoring confidence. The relaxation of fiscal policy in the short run was justifiable on countercyclical grounds but medium-term commitments lacked credibility. The implicit assumption that the fiscal design of the program would suffice to restore confidence was highly doubtful.
- The justification given for the limited recourse to the SRF (to avoid a hump in debt service in 2002 and 2003) was inconsistent with the premise that normal market access would be restored in the near term.
- The prior actions agreed to by the authorities—which involved an executive decree to overrule the legal action of Congress that contradicted the program—confirmed the commitment of the authorities, but not that of the rest of the political system. A broad political consensus, vital for the restoration of Argentina's fiscal heath, was lacking.[13]

Figure 3.1. IMF and Private Sector (Consensus) Forecasts for Key Program Variables



Sources: IMF staff reports; and Consensus Economics, Inc.

Although not all indicators of market access prospects were signaling alarm,[14] there were worrisome signs. Projected financing requirements, for example, exceeded $30 billion a year for the foreseeable future. Total external debt service was projected to amount to 100 percent of export receipts in 2001.

nario considered only the impact of a modest shock (for example, GDP growth lower by one percentage point, interest rates higher by 100 basis points, or foreign demand lower by half a percentage point). None of the three scenarios included in the report (in addition to the baseline) explored the impact of either a large shock or a combination of shocks.

[13]This was well understood by at least some in the IMF. A staff memorandum to management in early December 2000 stated: "the track record of the government in its first year of office [has] been relatively poor in terms of implementation of announced measures." Furthermore, in a memorandum to management dated December 29, 2000, the staff noted that its "concerns about ownership of the program by the political class have been confirmed by the attitude of Congress, which in the end refused to support the government in some of the essential, but politically more difficult elements of the program."

[14]These indicators are: (i) characteristics of the economy that have a bearing on its ability to service additional external debt; (ii) previous levels of market access and market indicators; (iii) strength of the macroeconomic and structural policy framework; (iv) authorities' commitment to sustain the implementation of the reform program; (v) level of reserves and availability of financing; (vi) stage of the crisis; and (vii) shifts in portfolio demand (such as those caused by an anticipation of devaluation). See, for instance, the Managing Director's statement in "Status Report on Private Sector Involvement in Resolving Financial Crises," June 2000.

Gross international reserves only covered an estimated 80 percent of short-term external debt. While staff did not have an estimate of the extent of overvaluation of the REER, its sharp appreciation in the previous three years, along with the impact of other recent shocks on the equilibrium exchange rate, made it likely that it was in fact significantly overvalued. Furthermore, the unwillingness of Congress to support key elements of the policy package also cast doubt on the authorities' ability to adhere strictly to the program.

In assessing the decision of January 2001, it is necessary to recognize that the decision involved considerable uncertainty and cannot be judged to have been wrong ex ante just because it failed to yield the intended result. We must instead consider whether the decision had a reasonable chance of success ex ante, keeping in mind that the costs of any alternative strategy would have been high. With all these caveats, the evaluation suggests that an objective assessment of Argentina's difficult economic and political situation at the time would have revealed that the probability of success of the catalytic approach was indeed low, if all the risk elements had been fully taken into account.

Nevertheless, it could be argued that, despite all the odds against it, there was a case for giving a country with an otherwise reasonable record the benefit of the doubt. In view of the considerable risk involved, however, *the decision to support Argentina in January 2001 should have been accompanied by a better anticipation of unfavorable outcomes and a clearer understanding of an exit strategy in case the chosen strategy did not work. The failure to do this, rather than the decision itself, represents the critical error in the second review*. In keeping with the spirit of the policy on exceptional access, the program effectively incorporated a market test, but the conditions for judging success or failure were not made explicit, and there was no discussion of what the next steps would be in the event that the catalytic approach failed.[15]

Completion of Third Review, May 2001

Background

The January 2001 augmentation appeared to succeed initially, at least in the sense of reducing spreads below their precrisis level and allowing Argentina to regain market access for a short period.[16] Policies agreed in the program, however, were not fully implemented. In late February 2001, it became evident that fiscal performance had slipped significantly, and that with unchanged policies the federal deficit for the year would reach $10 billion (instead of the targeted $6.5 billion).[17] On the structural side, the two decrees reforming the pension and health care systems, which had been issued as prior actions for the January augmentation, were challenged in the courts and suspended. Spreads rose again to crisis levels. Three major credit rating agencies downgraded Argentina's sovereign debt.

In early March, José Luis Machinea was obliged to resign as Minister of Economy, and his successor, Ricardo López Murphy, proposed a fiscal adjustment that would have narrowed the deficit by about 1 percent of GDP, mostly through spending cuts. The program provoked strong political opposition and, after an initial show of support, the president forced his resignation only two weeks after he had been appointed. This was a significant blow to market confidence, because it seemed to show that, even under conditions of extreme economic crisis, the Argentine political system was incapable of supporting even a relatively modest step toward the implementation of a sound fiscal policy. It led to an acceleration of deposit withdrawal (Figure 3.2).

The appointment, in late March, of Domingo Cavallo as Minister of Economy initially succeeded in calming the fears of depositors and market participants, as he brought with him a high degree of popular support and international credibility. In an unusual show of unity and recognition of the urgency of the situation, Congress granted special quasi-legislative powers to the executive by enacting the Economic Emergency Law and agreed to institute a financial transactions tax, leaving the government free to set the tax rate. These developments temporarily boosted expectations that strong fiscal adjustment could be rapidly put in place.

As it turned out, the appointment of Minister Cavallo heralded a radical departure from the more orthodox policy stance of the previous two ministers and the generally cooperative relationship that had

[15] In a January 2001 memorandum, WHD expressed the view that "if activity were to continue to stagnate over the next six months, and market concerns were to intensify, the whole strategy should be rethought." However, this stance was never explicitly endorsed by management or even by review departments, let alone implemented.

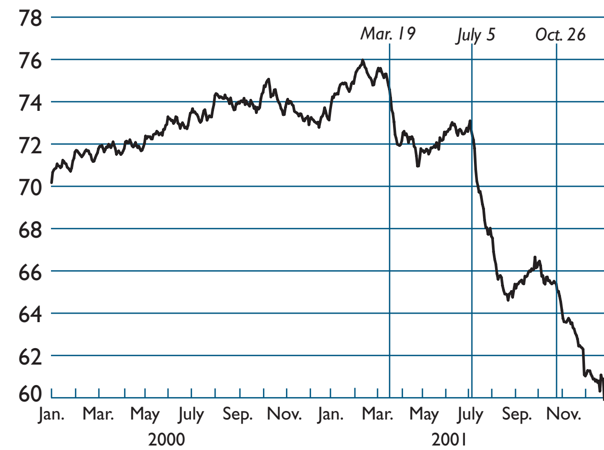
[16] Following the approval of the augmentation, the government was able to implement its financing plan at interest rates substantially lower than those assumed in the program. These developments led staff to comment in memorandums to management in mid-February that there had been a "marked change in perceptions about the country's prospects," and to suggest that the authorities might wish to discuss returning to a precautionary treatment of the arrangement at a forthcoming meeting.

[17] The outturn for March 2001 would show that the federal deficit target was missed by Arg$1 billion (or 30 percent) over the program ceiling, of which about a third was due to expenditure overruns.

existed between the IMF and the Argentine authorities.[18] The new minister soon announced a series of measures that modified substantively the nature of the economic program to be supported by the IMF, while reaffirming commitments to the convertibility regime and to the fiscal targets of the original program. Further announcements of dramatic policy shifts followed, all with little or no prior consultation with the IMF (see Box 3.3 for details). Many of these measures were counterproductive in restoring market confidence, especially the proposal to alter the convertibility regime, the dismissal of the central bank governor, and the relaxations of bank liquidity requirements. These actions seriously undermined ten years' worth of policies toward establishing central bank independence and strengthening the capital and liquidity position of the banking sector.

With no signs that growth was picking up any time soon, a drop in tax compliance, and paralysis at the political level, all the fiscal targets for the first quarter were breached by large margins (Table 3.2). Seven out of the 10 structural benchmarks set in January were observed, but the critical measures envisaged in the areas of provincial finances, pension and health care reforms, and tax amnesties had not been taken. Despite evident underperformance on these important dimensions, the IMF Executive Board on May 21 unanimously approved management's recommendation to complete the third review of the SBA by granting waivers for the substantial slippage in compliance with the end-March performance criteria, thus allowing the disbursement of the $1.2 billion tranche.

Figure 3.2. Bank Deposits, January 3, 2000–December 31, 2001
(In billions of pesos)



Source: Bloomberg.

Program design and strategy

The economic program needed to be revised to compensate for the fiscal slippages recorded in the first quarter (Figure 3.3), and to find additional or alternative policies to rekindle growth, as the expected pickup had failed to materialize. The revised program had three pillars: (i) putting fiscal adjustment back on track, in particular by introducing a high-yield financial transactions tax (so that the original year-end targets would be observed);[19] (ii) boosting competitiveness (through the competitiveness plans previously announced by Mr. Cavallo); and (iii) implementing a voluntary, market-based, "mega-swap" of government bonds to reduce the near-term financing needs of the federal government, though very little information was available on its nature, its cost, and its impact on the debt dynamics. The main assumptions were that GDP growth would gradually build up to 5 percent in the last quarter, achieving an annual average of 2 percent, investment would pick up to 7 percent in the fourth quarter, and exports would grow at 11 percent in 2001 as a whole.

The staff report advanced three main reasons for supporting the completion of the review: (i) the strength of the new measures that had been announced by Mr. Cavallo (although the staff was also critical of several of them, especially the competitiveness plans and the timing of the proposed modification of the convertibility law); (ii) the authorities' demonstrated commitment to the program (backed by a show of support from Congress, which had granted exceptional powers to the executive); and (iii) the importance of Argentina's stability for the region and emerging market economies in general. Equally important, the staff initially felt compelled to give the benefit of the doubt to the new Minister of Economy, and was concerned not to force an abrupt and hence disorderly collapse of the policy regime. The staff report noted that "a change in the [convertibility] regime would likely have large adverse consequences on the balance sheets of the nonfinancial private sector, the banking system and the public sector, with a generalized disruption and dislocation of the economy."

[18]The IMF continued to maintain a cooperative relationship at the technical level, but its impact on Argentina's decision making became increasingly limited.

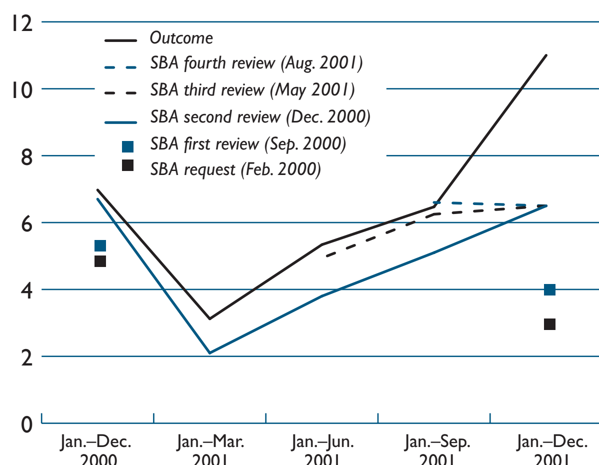
[19]The proceeds from the financial transactions tax were not subject to revenue sharing with the provinces and could have gone a long way toward closing the fiscal gap, had the proceeds not been used to support the competitiveness plans and the convergence factor.

Table 3.2. Fiscal Performance Under the Stand-By Arrangement in 2001
(In millions of pesos)

	Target (As Set at Previous Review)	Adjusted Target	Outcome	Margin[1]	Margin Relative to Original Target[1]
January–March 2001					
Overall fiscal balance of federal government	–2,100	. . .	–3,122	–1,022	
Primary expenditure of federal government	13,313	. . .	13,684	–371	
Change in federal stock of debt	2,150	1,311	1,791	–480	359
Change in stock of debt of consolidated government	2,750	1,903	2,457	–554	294
January–June 2001					
Overall fiscal balance of federal government	–4,939	–5,469	–5,339	130	–400
Primary expenditure of federal government	26,657	. . .	26,429	228	
Change in federal stock of debt	5,039	7,025	6,973		–1,934
Change in stock of debt of consolidated government	6,639	8,762	8,394	368	–1,755

Source: IMF staff reports.
[1]A negative sign indicates a shortfall.

Figure 3.3. Evolution of Fiscal Deficit Targets and Outcomes
(In billions of pesos)



Source: IMF staff reports.
Note: Targets refer to the overall cumulative deficit of the federal government.

The staff noted that, with the new measures outlined by the authorities (combined with the provisions of the previously enacted Fiscal Responsibility Law) and on the basis of conservative growth and interest rate assumptions, the debt dynamics would be sustainable. On the scale of exposure of the IMF, Argentina's debt-service indicators were recognized to be "relatively high compared to other members," but the country was believed to "be able to meet fully its obligations to the Fund based on its impeccable track record."[20] Although the staff noted that "the program [faced] significant risks," it identified only a few in terms that did not suggest a high probability (such as, "growth may take longer to recover than now envisaged," "interest spreads may not decline as fast as needed," and "tax compliance is difficult to enforce and improve in the short term"). The staff report added that the process of placing the debt-to-GDP ratio on a declining path, assumed to be the key to a virtuous circle out of the crisis, "[depended] crucially on firm implementation," thereby suggesting that whatever risks existed could be handled by decisive action.

Additional considerations

Internal memorandums suggest that staff was much more concerned about the viability of the program than indicated in the staff report.[21] In particular, a note sent to management in March 2001 indicated that Argentine society was showing signs of "adjustment fatigue," which would make it difficult to sustain the adjustments and fiscal discipline needed to ensure external viability. It further referred to indications of wavering support for the convertibility regime, noting that "some well-connected commentators and analysts have recently started calling for changes to the currency board regime." In early May, staff contacts

[20]This statement was factually incorrect, as Argentina had previously incurred arrears to the IMF, most recently in the late 1980s.

[21]Management shared these concerns, asking staff to consider alternative scenarios for Argentina. Management also advised Mr. Cavallo to prepare a contingency plan, but no substantive discussion with the authorities took place on possible options.

with major New York-based investment banks revealed that market participants were skeptical of the policy plans outlined in the just released LOI, not least because they perceived the authorities as lacking credibility to implement them. Even more explicitly, a note from the "Argentina Task Force"[22] in late April (about two weeks prior to the issuance of the staff report to the Board) conveyed to management its judgment that "the probability of a full-blown crisis in Argentina has increased. Avoidance of such an outcome seems unlikely, though not impossible."

Analytical work on contingency scenarios by IMF staff continued, with two key messages emerging. One involved consideration of two possible paths to the outbreak of a full-blown crisis if market sentiment failed to improve: (i) a passive scenario in which the current strategy was maintained until the very end and (ii) a proactive scenario in which drastic preemptive actions were taken on the debt and deposit fronts (for example, a debt standstill, a temporary freeze on deposits, or a temporary suspension of convertibility). Although the proactive approach was the staff's preferred choice, the passive approach was seen as more likely to be adopted by the authorities, given the politics of the situation. In that case, the staff pointed out that "its eventual unraveling, after reserves have been eroded, will be catastrophic for the Argentine economy."[23] The other message that came out of the analysis was that the banking system posed the greatest challenge in the debt restructuring and devaluation scenarios (even under relatively mild assumptions). Even if an intensification of the ongoing run on deposits could be averted, which appeared doubtful, very large injections of public funds would be needed to avert the banking system's complete collapse in either case.

The Board decision

The Board accepted management's recommendation to complete the review, but not because of confidence that the program was sustainable. The Summing Up makes it clear that Directors' assessment of the economic outlook and the program's prospects was bleak. It noted that the recent crisis had been brought about, not by exogenous shocks, but by the authorities themselves through "an unexpected relaxation of the fiscal stance"; that several of the measures taken in recent weeks by the authorities were very questionable in substance (such as the tariff increase, the financial transaction tax, and compromises made with central bank independence and the liquidity requirements of the banking system) or in timing (as in the announcement of a modification in the convertibility regime), and even more so as they had been taken against the advice of the IMF.

The only positive remark the Board could make about the proposed program was regarding the authorities' commitment to adhere to the year-end fiscal targets for 2001 and to advance the agenda of structural reforms, particularly in the fiscal area, and their reaffirmation to preserve the independence of the central bank and the high capital and liquidity positions of the banking system despite the contrary actions already taken. While most Directors took positive note of the statement of the Argentine representative on the Board affirming that "the political class understands what is at stake and, once again, is supportive of decisive actions," several Directors noted that similar statements had been made at the time of the *blindaje* but were followed by poor program implementation.

The Board's assessment of the forthcoming debt swap was guarded. While all Directors welcomed it in principle, they also deplored the lack of details about its terms and conditions. They noted that, depending on these, the debt swap could either enhance or jeopardize debt sustainability. In fact, several Directors even expressed the view that, at current spreads, going ahead with the swap would lock in interest rates that would prove unsustainable in the medium term but recognized that, the announcement having been made, delaying or canceling it would be likely to have dramatic adverse effects. A few Directors made it clear that this was the last chance before a more coercive debt restructuring would need to be made in order to reduce the net present value (NPV) of the debt. Last but not least, several Directors questioned the feasibility of the promised fiscal adjustment, noting that once again it was predicated upon optimistic growth assumptions and that the same structural problems (particularly in the area of tax collection) that had proved to be a hindrance in the first quarter remained unaddressed.

Why, then, did the Board agree to the completion of the review? The Chairman's Summing Up of the Board meeting noted that "in sum, Directors felt that the authorities have responded promptly and effectively and that the new measures merit the strong support of the international community." According to the statements of individual Directors, many of them were concerned that withholding support at this juncture would be tantamount to "shying away" from the mandate of the IMF and to effectively surrendering to the same "procyclical influences that are driving market behavior." Several justified their support, in spite of serious reservations, by the im-

[22]An interdepartmental team assembled in mid-1999 to undertake analytical work on Argentina, parallel to the process of program negotiations and reviews in which WHD took the lead. See the section "The Decision-Making Process" for details.

[23]"Argentina—Possible Crisis Scenarios," sent to management on April 14, 2001.

portance of Argentina's stability for the region and emerging markets in general. In the words of a Board member representing a large shareholder, the main rationale for the Board's support of a program that Directors viewed as deeply flawed was that "no one has proposed a different strategy that, risk adjusted, promises a less costly alternative."

Overall assessment

The decision to complete the third review in May is much more difficult to justify than the January decision. All the indicators for gauging market access prospects were now sending negative signals, except for those regarding the authorities' commitment. The revised program design offered no reasonable prospect of making Argentina's situation sustainable. The assumptions on growth and interest rates may have been conservative when compared with the V-shaped recovery that followed the Mexican crisis, but were in fact quite optimistic relative to the contemporary consensus forecast (see Figure 3.1), especially regarding GDP growth. Fiscal slippages were to be corrected by a sharp adjustment that would be heavily concentrated in the fourth quarter (as indicated by the slope of the cumulative deficit target lines in Figure 3.3), which was neither realistic nor helpful to the credibility of the program. The announced megaswap had every characteristic of "gambling for redemption" by the authorities (see Appendix 7). In addition, the new policy measures taken by the authorities were misguided in many respects and insufficient to ensure compliance with the programmed fiscal adjustment path. It is doubtful, at this point, that any program could have achieved a sufficient turnaround in confidence to spur the expected rebound in growth, but the measures on which this one was based could even make things worse.

The decision required a difficult balancing of judgments of (i) a low probability that completing the review would succeed in staving off a crisis and (ii) recognition that such a crisis would be very costly. As pointed out earlier, it is important to avoid concluding that the decision was wrong just because it failed, but our assessment is that it had very little chance of success, taking into account what was known at the time:

- The program was effectively off track and several of the measures designed by the authorities in response—such as the competitiveness plans in particular—contradicted IMF advice.
- Even with optimistic assumptions, a return to sustainability looked doubtful.
- Market spreads remained at prohibitive levels. According to the logic of the catalytic approach that underlay the January augmentation, this fact alone should have provided ample reason for refusing to complete the review on the terms requested by the authorities.
- The desire to help a member country under stress was entirely commendable, but the key consideration should have been whether the strategy proposed was sustainable under realistic assumptions and, if not, whether the country's interests (as well as those of the international community) would be better served by proposing alternative solutions to its problems.[24] It was simply assumed that keeping Argentina afloat for however long the $1.2 billion would buy was the best strategy.

At this point, at least two other options could have been considered: (i) helping Argentina undergo a drastic change in the macroeconomic policy framework immediately (involving a change in the exchange rate regime and debt restructuring, embedded in a broader, coherent economic reform plan); and (ii) explicitly using the time "bought" by the augmentation to make a transition to an alternative regime while giving the catalytic approach a last chance, by negotiating a fully credible policy package combined with debt restructuring. But the IMF had no viable alternative plan to offer, and the authorities refused to discuss such alternatives. This became a reason for continuing to support a strategy with a low probability of success.

Fourth Review and Augmentation, September 2001

Background

After the completion of the third review, the economic situation deteriorated even further. The megaswap, completed in early June 2001 at spreads of just under 1,000 basis points (compared to around 800 assumed as a working hypothesis at the time of the third review), entailed substantial costs for the cash flow savings obtained. The operation received a mixed appraisal from market participants, but whatever positive effect it may have had on spreads was quickly erased by the confidence-shaking impact of a new set of measures announced by the Minister of Economy in mid-June without prior consultation

[24]This is not to suggest that a fully quantitative analysis of the expected costs and benefits of various options could have been undertaken. It would have been a tall order to fill under the circumstances. The Board discussion, however, was not informed by any systematic analysis of different options going beyond the very near term.

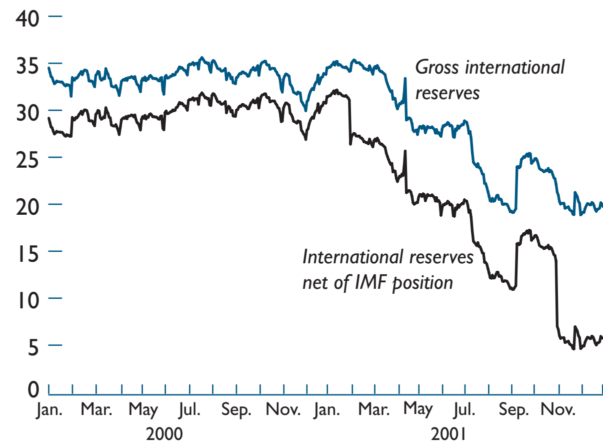
with the IMF. These included the so-called "convergence factor," which amounted to a devaluation for the nonenergy tradable goods sector by mimicking the proposed basket peg announced earlier through fiscal means.[25] Contrary to the intention of boosting competitiveness, the signal it gave to the markets was an admission that the exchange rate regime was no longer viable.

In early July 2001, faced with the refusal of the domestic financial sector to provide any more credit to the government, the Minister announced a "zero deficit policy," which was passed into law by Congress later that month. The law mandated the government, in the event of a prospective deficit, to introduce across-the-board proportional cuts in primary expenditures. There was considerable skepticism that the wage and pension cuts implied by the law would be politically sustainable, but more than anything it confirmed the dire liquidity situation of the government. Meanwhile, deposit runs intensified (see Figure 3.2), accompanied by a sharp reduction in international reserves (Figure 3.4). Spreads continued to climb, reaching 1,600 basis points by late July.

In late July, facing the prospect of a banking crisis if deposit runs could not be stopped, the authorities requested the IMF for the rapid disbursement of a large amount of support. In response, the IMF initially announced that it would consider accelerating disbursements under the existing arrangement, but a couple of weeks then passed without any confirmation of this move, leading to great uncertainty as to what the next step would be. In the meantime, the Argentine authorities fed assurances of international support to the media, and nuanced statements of support were expressed by various world leaders, including from France, Spain, the United Kingdom, the United States, and many Latin American countries.

Internal documents and interviews with key officials indicate that decision making in the summer of 2001 was particularly arduous. In August alone, no fewer than six informal Board meetings were held on Argentina, not to mention the daily meetings of management and senior staff and regular contacts with the treasuries and finance ministries of major shareholder governments. Several options were considered by management, but when Executive Directors returned from the summer recess on August 20, they were only presented with three:

Figure 3.4. International Reserves, January 3, 2000–December 31, 2001
(In billions of U.S. dollars)



Sources: Bloomberg; and IMF database.

- Option 1. Augmenting the existing arrangement by $8 billion in support of an enhanced version of the existing strategy;
- Option 2. Putting together a program (of unspecified design) with large amounts of money ($30–40 billion) from the official sector; and
- Option 3. "Rethinking the entire strategy" (i.e., changing the exchange rate regime, restructuring the debt, or both).

They were then told in no uncertain terms that failure to act quickly would precipitate default and a collapse of the exchange rate regime.

After some initial hesitation, on August 21, the Managing Director recommended a version of option 1 that included a "creative element" in the form of a possible use of $3 billion as an enhancement in support of a debt restructuring operation.[26] According to participants in the meeting, the reaction of the Board was largely positive, but several Directors, including some from G-7 countries, wished to reserve their positions at that point.[27] In a press release is-

[25]A subsidy was to be paid to exporters and a duty charged to importers, with the amount equivalent to the difference between the prevailing exchange rate and the exchange rate calculated by the basket. Although this was effectively a dual exchange rate, it was determined by IMF staff that, from a legal standpoint, it did not constitute a multiple currency practice (use of which is restricted by the Articles of Agreement), because the system operated through the budgetary process, and not through the foreign exchange market.

[26]It appears that this idea, a surprise to most Directors, had been raised by senior U.S. Treasury officials over the preceding days in direct conversations with the Managing Director.

[27]As a result, the press release only announced the Managing Director's intention to recommend that decision to the Board, instead of stating that the Board supported that decision (as had been done in the case of the *blindaje* announcement in December 2000).

sued on that day, the Managing Director made public his intention to recommend to the Board an augmentation of the existing SBA by $8 billion in support of an essentially unchanged program, though with an option for debt restructuring.

Program design and strategy

The main pillar of the revised program was the zero-deficit policy, which had been enacted into law by Congress in late July. It was hoped that restoring a viable fiscal position would help halt the outflow of deposits and ease domestic financing conditions. This was expected to help create conditions for a recovery of demand and output, beginning in the fourth quarter of 2001, combined with trade and tax measures removing impediments to investment, "competitiveness plans" aimed at improving profitability in the sectors most affected by the recession, and the introduction of the "convergence factor" (see Table 3.1 for details of the macroeconomic framework). In order to give credibility to the authorities' commitment to fiscal adjustment, two prior actions were set, involving a public announcement ahead of the Board meeting that cuts in guaranteed transfers to the provinces might be implemented if required to meet the zero deficit target and that a reform of revenue-sharing arrangements would be presented to Congress before year-end.[28]

The staff report was unusually candid in spelling out the risks to the program, which were "all the greater in light of the Fund's increased exposure to Argentina." It noted the likelihood of strong political resistance to key components of the program, the vulnerability of the banking sector to further deposit runs, the worsening of several external vulnerability indicators, and the fact that the authorities had only a few months to reestablish the credibility required to meet their large financing needs for the following year.

The staff report also used guarded language to pronounce on debt and current account sustainability. Remarkably, the relevant paragraph of the report did not include the usual expression of staff confidence in the authorities' ability to repay the IMF. While it concluded that "overall, the staff is of the view that Argentina's program deserves Fund support," the reasons invoked to support that view essentially boiled down to the authorities' resolve and had little to do with the likelihood of being able to restore sustainability. Mitigating somewhat this guarded appraisal, in comments made at the Board meeting, the staff further asserted that the risks and costs of alternatives, involving a debt standstill, devaluation or both, would be far greater.

Additional considerations

Looking beyond Argentina, the staff considered potential contagion both within and outside the region, and outlined tentative policy responses for the countries most likely to be affected. Notes produced by the staff throughout the summer of 2001 reveal uncertainties as to whether contagion would be greater in the event of a preemptive debt restructuring (possibly leading to a generalized withdrawal of capital from emerging markets) or in the event of a devaluation forced by markets. RES concluded that the potential for contagion from an Argentine default would likely be limited because a "credit event" was already widely anticipated and had been partly discounted by markets for some time, while contagion could be worse if the IMF tried to stall it.[29]

Starting in July, internal discussions within staff and with management became more focused on what the stop-loss rule should be for the IMF. By mid-July, staff communicated to management the view that unless credibility was gained quickly, which was considered possible though unlikely to be sustained beyond a few months,[30] "it would be advisable to adopt alternative measures before the reserves are depleted and major damage is done to the banking system. . . . If and when problems reemerge, it will not be advisable to seek to maintain the situation much longer." At the same time, the staff felt that the authorities would probably hold on to their strategy until liquidity constraints became insurmountable.

By end-July, notes to management further expressed the staff's view that a reduction in the NPV of the debt was likely to be needed under all scenarios. It was estimated that, under the current exchange rate regime an annual primary surplus of 4½ percent of GDP would be needed through 2006 to make the debt sustainable, an unlikely development given that the primary surplus never reached 2 percent in the previous decade.[31] One of the memorandums drafted

[28]These prior actions were discussed, but not explicitly characterized as such in program documents.

[29]Similar views were expressed to the Board by the Director of the International Capital Markets Department (ICM) in an informal meeting in late August.

[30]An informal report on an interdepartmental staff meeting on vulnerabilities held on July 12, 2001, noted: "There was consensus that the situation in Argentina was not sustainable [in view of the level of international spreads and domestic interest rates] and a strategy that lacks political credibility and support."

[31]The debt dynamics simulation presented by staff in January 2001 had assumed that the primary surplus of a similar magnitude could be achieved in 2005, but it was envisaged that the reduction would be made gradually against the background of strong GDP growth.

by the Argentina Task Force around this time even suggested that "if, at some point, the program agreed with the authorities were to go irremediably off track, [it would] quickly bring about a collapse of the current policy regime." It then predicted with striking accuracy how the crisis would unfold.[32]

Despite these reservations, by mid-August 2001, the staff came to the view that completing the review without augmentation was effectively ruled out by expectations formed in the markets; the authorities had made statements during the previous weeks—without any denial from IMF or G-7 officials—that they received concrete commitments for an additional $9 billion of financing. Staff felt that not fulfilling these expectations would almost certainly trigger a speculative attack on the peso, leading to a depletion of foreign exchange reserves and a debt default.[33] In order to justify the augmentation, the staff tried to commit the authorities to a series of measures, mostly on the fiscal front, which it thought would strengthen the credibility and feasibility of the required fiscal adjustment. But the staff was unable to obtain the authorities' agreement on more than a few of these measures.[34] On its part, management secured a commitment from the authorities to engage in discussions with the IMF on an alternative policy framework in the event international reserves fell below a critical threshold (effectively set just above the balance of outstanding IMF credit).

In a meeting of selected senior staff called by the Managing Director, about a week before the final decision was made, the chance of success of the program was estimated at most as 20–30 percent.[35] The staff was divided as to whether it was still significant enough to complete the review, given the enormous costs of withholding support. Those who were in favor argued that the augmentation would buy time (four to five months at most) and ensure that the authorities, not the IMF, took responsibility for the critical decisions needed (that is, a change in the exchange rate regime and debt restructuring). It was also argued that the costs to the Argentine people, neighboring countries, and the IMF itself would be less if the authorities were given a last chance to demonstrate the viability of their strategy.[36] However, a clear majority of those present disagreed, saying that the IMF might not be spared from blame in any case. The additional few billion dollars would not buy enough time to make a difference, but would be more likely to disappear in capital flight, leaving Argentina more indebted to the IMF. According to some present at the meeting, a key element in management's eventual decision was concern about a political backlash against IMF policy advice, especially in Latin America, if it was perceived to withhold support from a country that had been under IMF-supported programs for the last decade and was ostensibly committed to implementing its agreement.

Right before the formal Board meeting, management was informed of the findings of a just-completed staff visit to Buenos Aires. In the staff's view, given the recession-induced fall in tax revenue and tax compliance, the (already relaxed) fiscal targets for end-September would likely be met only through unsustainable measures (for example, payment arrears) and accounting maneuvers, and the authorities would likely not comply with their promise to cut guaranteed transfers to the provinces, which had been a key condition to ensure short-term fiscal sustainability.

[32]The memorandum described the evolution of the crisis as follows. "During the first few weeks of traumatic adjustment towards a more sustainable position, a number of events will likely take place in rapid succession, including: a default on government debt; the abandonment of the currency peg; a sharp decline in activity and spike in unemployment; a deterioration of banks' balance sheets; political dislocation. . . . In the event, steps could be taken to make the transition process somewhat less chaotic [and] the Fund could offer a number of short-term recommendations: (i) the announcement of the debt moratorium should be followed by a combination of defensive legal actions and the government should organize a preliminary meeting as rapidly as possible with domestic and external creditors; (ii) any bank holiday must be short and should be used only to provide the authorities time to develop a credible policy package; for the same reasons, the authorities should not try to impose a deposit freeze; (iii) the new exchange rate regime will need to be perceived as part of a sustainable policy mix; (iv) the government will need to strengthen the Central Bank; (v) [it] will need to start working immediately on a set of policies that will achieve a fiscal position that is credible and visibly consistent with a quick resumption of fiscal viability, including debt service payments."

[33]Interestingly, providing support of that magnitude was seen by many market participants at best as a "middle of the road" solution, likely to be insufficient to buy Argentina more than a few weeks of respite. Market views of what it would take to "bail out" Argentina ran in excess of $30 billion, a figure corresponding to option 2 considered by management. See, for instance, "Argentina's Final Crisis Resolution," *BNP Paribas Emerging Markets Trade and Sovereign Strategy,* August 14, 2001.

[34]The measures refused by the authorities included various provisions to safeguard the existing tax revenues, abolishing the competitiveness plans and associated tax exemptions, speeding up progress in pension and health care reforms, obtaining written commitments from all provincial governors on fiscal discipline under the zero-deficit law, and strengthening the state-owned banks.

[35]The minutes of the meeting state that those who were more optimistic considered the "chance of success" to be "20–30 percent," while at the same time acknowledging that "precise quantification was not really meaningful." Management may well have held a somewhat more optimistic view, as a member of management has indicated to the IEO, but it was generally recognized that the probability of success was low.

[36]Obviously, this argument assumed that the strategy chosen would work.

Box 3.2. Financial Instruments Used During the Crisis

During 1999–2001, Argentina made use of various market-based financial tools to manage its financial needs. These included: (i) voluntary debt restructuring operations without official enhancements; (ii) public guarantees and other enhancements to induce the provision of private financing; and (iii) private contingent credit lines.

First, a voluntary debt restructuring operation was done without official enhancements in the mega-swap of June 2001, in which 52 old bonds totaling about $30 billion (in face value) were exchanged for five new bonds with longer maturities.

Second, a public guarantee and an official enhancement were provided, respectively, by the World Bank's policy-based guarantee (PBG) loan and the proposal to use $3 billion of IMF money for debt operations in the September 2001 augmentation. Argentina, however, eventually defaulted on the PBG loan when it opted not to pay the Bank for the guarantee the Bank had exercised. The $3 billion made available in September 2001 was not used for debt operations, as it became evident very quickly that there was no effective way of using this relatively small sum to reduce the debt burden of Argentina.

Third, credit lines with a group of international banks were maintained by the central bank in order to provide liquidity support to the domestic banking system, through guaranteed sales (with a promise to repurchase) of Argentina's international bonds in bank portfolios for cash. The mega-swap of June 2001, however, reduced the amount of eligible bonds, and effectively reduced the size of the facility. Argentina did draw on the facility in September 2001, but the credit line was too small to provide the sums the country needed.

For further details, see Appendix 7 on the mega-swap and Appendix 8 on public guarantees, official enhancements, and private contingent credit lines.

The Board decision

On September 7, 2001, the Executive Board approved the recommendation of management to complete the fourth review of the SBA and to augment the arrangement by SDR 6.3 billion ($8 billion), of which SDR 3.97 billion ($5 billion) were to be disbursed immediately and $3 billion set aside to be made available in support of a possible debt restructuring operation (Box 3.2). In a move that is rare in the IMF's consensus-based decision-making process, two Directors abstained. The decision brought total commitments under the arrangement to SDR 17.5 billion ($22 billion). Unlike the announcement of the *blindaje* in late 2000, the advance announcement of the IMF's decision to support Argentina brought only a short-lived relief in market conditions, and spreads had quickly returned to reach 1,400 basis points by the time of formal Board approval.

At the informal Board meeting of August 20, Directors were told by management that augmenting the arrangement in support of enhanced policies within the same framework had a low probability of success. As noted, on the next day, the same option, enhanced by the possibility of using IMF resources in support of an unspecified market-based debt restructuring operation, was presented by management as the least costly and risky of various alternatives under the prevailing circumstances. At the same time, management shared with Board members notes prepared by the Directors of RES and ICM, each expressing skepticism as to the advisability of using IMF resources in support of a voluntary debt restructuring operation, even leaving aside the intricate legal issues involved.[37]

According to the minutes of the Board meeting of September 7, 2001, a number of Directors felt that the situation was not sustainable and that the program did not offer satisfactory remedies. Nevertheless, with the exception of two Directors, the Board expressed its willingness to support the program, ostensibly to buy the authorities (and the international community) time to put together a solution that would be both less disorderly and less costly than an immediate collapse of the regime. Many Directors were particularly concerned with the impact that a default in Argentina would have on the world economy, at a time when the global outlook was worrisome.[38] All Directors appeared impressed by the strength of what they saw as the authorities' resolve, and some wished to give them the benefit of the doubt on their ability to implement the measures they had announced. A handful of Directors even thought that the program had a good chance to work, provided that it was perfectly implemented and received the enthusiastic support of the IMF.

Overall assessment

The September 2001 augmentation suffered from a number of weaknesses in program design, which were evident at the time. If the debt were indeed un-

[37]Specifically, the note from the RES Director concluded that "as a rule, financial engineering can dissipate our resources but cannot enhance them," while the note from the ICM Director further explained that "it is very hard to see how a voluntary exchange, accompanied by a relatively small amount (compared to total debt) of credit enhancement via Fund finance for interest payments, can result in a significant improvement in Argentina's debt service profile, no matter what financial engineering is involved."

[38]Further evidence of such concerns is provided by the minutes of the Board discussion on the WEO, which coincidentally was concluded on the same day that the Argentina program was approved.

sustainable, as by then well recognized by IMF staff,[39] the program offered no solution to that problem. While implicitly acknowledging the need for debt restructuring by including a component for that purpose, the program provided no information on the nature or scale of this operation. In any case, it was certain that the debt operation could not, in and of itself, offer much by way of achieving debt sustainability, unless much larger amounts of financing could be mobilized.[40] The way the operation was presented, it might even be perceived as signaling that a coercive debt restructuring was imminent and thereby risked further undermining market confidence.

The program was also based on policies that were either known to be counterproductive (such as the so-called convergence factor) or that had proven to be "ineffective and unsustainable everywhere they had been tried" (as was the case with the zero deficit law).[41] Nor did the program address the now clear overvaluation of the exchange rate, which had appreciated by an additional 7.7 percent by September 2001.[42] The fiscal component of the program remained weak or unconvincing. The fiscal targets for the current quarter had to be relaxed preemptively, and all the adjustment effort was therefore concentrated in the last quarter.[43]

At best, the amount provided offered Argentina breathing space, perhaps until the end of the year, but it was simply not possible to expect Argentina to regain market access within such a short amount of time, given the prevailing market sentiment.[44] This meant that, unless the public sector's financing requirements could be reduced to zero, continuation of the strategy would require large amounts of *additional* financing to prevent a default, in violation of the terms of the SRF under which over half of the additional financing was provided. More significantly, it put at risk a considerable amount of IMF resources.

Although staff and management, in their reports to and communications with the Board, were for the most part candid in spelling out the risks to the program and to the IMF itself, the staff report did not discuss the following issues:

- The implications for future IMF financing of continued adherence to the strategy that was being recommended. These included the question of how much more "bridge" financing would be required from the official sector if the international community were to help Argentina until confidence returned and growth finally resumed.
- The risks and costs of the various alternatives. There was no analysis of what the next step would be, even though it was certain that continuing the program, with scheduled disbursements, was the least probable scenario. As a result, the Board could not assess if the recommended strategy was indeed the least costly and least risky one, and had only the choice between supporting a program with a low probability of success and withdrawing support entirely, thereby triggering an immediate collapse, with high costs and little idea of what strategy would follow. As in May 2001, the costs of providing further support to postpone a default and devaluation were not discussed.
- The findings of the staff visit that had occurred shortly before the Board meeting, which confirmed that the recommended strategy was already headed for a likely failure.

The Board was also not proactive in performing its oversight responsibility to safeguard the IMF's re-

[39]A memorandum to management dated July 26, 2001 noted: "While the results are highly sensitive to the assumptions, the staff estimates that a haircut of between 15 and 40 percent is required, depending on the policy choice."

[40]This was the conclusion of analytical work done inside the IMF, as well as of parallel work done by some U.S. Treasury staff. The Argentine authorities were aware of this, and the debt restructuring scenario on which they were working in fact involved enhancement in the order of $20 billion to 30 billion. Those outside the IMF supporting the idea of "earmarking" $3 billion for a debt operation seem to have hoped that this sum could work as seed money for further contributions from the official sector. However, the Argentine authorities were not successful in their attempts to secure additional official financing from bilateral sources during the fall.

[41]As expressed by FAD at the time.

[42]In the same July 26 memorandum, the staff stated that the peso was overvalued by as much as 15 percent.

[43]One review department put it as follows: "The realization of the medium-term debt scenario presented would represent a radical departure from this track record of slippages, optimistic macroeconomic assumptions, and inability of successive programs since January to arrest the growth of public debt."

[44]New York-based market participants interviewed by the IEO indicated that, by August 2001, all but a few international investors had eliminated or reduced their exposure to Argentina significantly in their expectation that a crisis was inevitable. That this sense of inevitability did not lead to a sharp increase in market spreads until the last months of the year likely reflects a combination of factors. First, it was widely expected that the official community would provide further support to Argentina, thereby delaying the explosion of the crisis for an uncertain amount of time. Second, while much larger spreads have been experienced by other countries that avoided a crisis (for example, Brazil in 2002), these episodes are generally associated with a special event that increases uncertainty, such as elections, against the background of otherwise sound economic fundamentals. In contrast, Argentina's spreads had remained high for a sustained period of time. Third, spreads cannot readily be translated into an implied probability of default, as they also incorporate expectations about the magnitude of the default. It is thus important to consider not only spreads but also other indicators in order to ascertain market views.

sources. The staff report made it plain that according to a variety of indicators the disbursement of the $5 billion tranche would make the IMF's exposure to Argentina among the riskiest in its history.[45] It did not include the usual expression of staff confidence in the authorities' ability to repay the IMF. Yet, only a few Directors expressed concerns about safeguards to the IMF's resources in their Board statements, despite the fact that none of them knew of the understanding reached between management and Mr. Cavallo on Argentina's need to consider an alternative strategy and discuss it with the IMF when international reserves fell below IMF exposure. A specific question asked by one of the two abstaining Directors on this point was left unanswered and not picked up by the Board.

Noncompletion of Fifth Review, December 2001

Background

By late October 2001, it had become clear that the augmentation of the SBA and the zero deficit policy had failed to bring about the hoped-for virtuous circle of stronger public finances, lower interest rates, and economic recovery. Argentina's economic performance continued to deteriorate in almost every respect, with GDP expected to drop by 4½ percent in 2001 and the fiscal position at end-September was weaker than originally programmed by 3 percent of GDP. Spreads had widened to unusually high levels, reaching 2,000 basis points at end-October. Yet, even at this late stage, staff continued to defer to the authorities' unwillingness to engage in an open discussion of alternative policy frameworks.[46]

On November 1, 2001, the Argentine authorities announced—again without prior consultation with the IMF—a new package of measures intended to give a decisive boost to competitiveness through tax incentives[47] and to make further progress in ensuring fiscal solvency, including a two-phase debt exchange, which was characterized as "orderly" as opposed to "voluntary." Phase I of the debt exchange was aimed mainly at domestic creditors and entailed an exchange of old credit for guaranteed loans to the federal government at substantially lower interest rates and longer maturities, collateralized by revenue from the financial transactions tax, while Phase II was to be directed at international creditors under international conventions.[48]

On the same day, responding to a request from management, staff outlined its own "preferred strategy" consisting of (i) further fiscal adjustment to ensure adherence to the zero deficit policy; (ii) a suitably comprehensive debt restructuring involving a reduction in the NPV of around 40 percent; (iii) dollarization at par (assuming it would be the authorities' preference); and (iv) repayment of SRF disbursements on an obligation basis and full disbursement of the balances undrawn under the SBA (i.e., $9 billion). This approach was made effectively irrelevant by the unexpected announcement of the authorities.

On November 2, 2001, in its communication to the Board, staff characterized the package of measures announced by the authorities on the previous day as being "not consistent with fiscal reality." It viewed the proposed debt exchange, unclear as it was at this stage, as running a major risk of being rejected by the markets and causing a bank run. Staff further noted that sustainability could not be ensured unless the provinces and the federal government could reach agreement on a new revenue-sharing mechanism, which they had so far failed to do in breach of program conditionality (let alone the requirements of the constitution). Board members asked questions but did not provide specific guidance as to the strategy to

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[45]The staff report noted that projected debt service to the IMF would reach 34 percent of total public sector debt service in 2002 (20 percent in 2003), and 23 percent of exports in 2002 (12 percent in 2003). The ratios of debt service to exports dwarfed those attained in any other previous capital account crisis case. The shares of debt service to the IMF in total public sector debt service were exceeded only in the cases of Korea and Russia, where debt service to the IMF never exceeded 7 percent of exports.

[46]In late October, when review departments were generally "of the view that the authorities were unlikely to be able to commit to a credible set of measures that would be sufficient," WHD feared the consequence of a possible leak and did not consider it prudent to include in a briefing paper explicit instructions for the mission chief to engage with the authorities in a discussion of alternative policy frameworks. Against the advice of review departments (especially FAD and PDR), management supported WHD's circumspect stance.

[47]By then, there was little doubt that the REER had appreciated since the start of the year, but to our knowledge no effort was made by either IMF staff or the authorities to calibrate the competitiveness plans to assess the extent to which they offset the exchange rate appreciation. Staff rightly criticized these measures for their fiscal cost, but to the extent that these measures were tantamount to admitting that Argentina had a competitiveness problem, it is likely that they also undermined confidence in the exchange rate peg.

[48]The two-phase approach was adopted for two reasons. First, a debt exchange under international conventions would take a much longer time. Second, the domestic banking system and pension funds needed to be protected from a possible capital loss resulting from coercive debt restructuring. In the event, phase I was completed on December 13, involving about $42 billion (or 34 percent) of federal government bonds, but phase II, which was to be completed in mid-January 2002, was overtaken by events and never executed. IMF staff had serious reservations about this structure because of the inter-creditor equity issues it raised and the likelihood that it would lead to a further erosion of investor confidence.

be followed, other than implicitly endorsing management's stance, as communicated to the authorities, that the next IMF disbursement would be dependent on a successful completion of the fifth review and full agreement on a program for 2002 and the 2002 budget.

In late November 2001, there was a renewed bank run in which more than $3.6 billion in deposits was lost over three days, bringing the cumulative decline since the beginning of the year to $15 billion (or 20 percent of total deposits). On December 1, the government introduced wide-ranging controls on banking and foreign exchange transactions, placing limitations on deposit withdrawals and purchases of foreign exchange for travel and transfers abroad. Meanwhile, a staff mission had arrived in Buenos Aires toward the end of November for negotiations relating to the completion of the fifth review. During those negotiations, it was evident that the staff's assessment differed considerably from that of the authorities on the prospects for achieving the fiscal targets.

The decision and its aftermath

On December 5, 2001, shortly after Minister Cavallo had made a statement that negotiations with the IMF were "going well," the IMF issued a press release indicating that the mission returning to headquarters on that day had concluded that the fifth review under the SBA could not be completed at this point, which also meant that the scheduled tranche of $1.3 billion would not be released. On the same day, management informed the Board that it could not recommend completion of the fifth review, because the fiscal deficit target of $6.5 billion for 2001 was likely to be breached by $2.6 billion, and projections for 2002 showed a large financing gap, in spite of the successful conclusion of phase I of the debt exchange. According to informal records of the meeting, Directors emphasized that the IMF should not be abandoning Argentina. Responding to Directors' questions about next steps, management indicated that the IMF would continue to work with the authorities on a sustainable program within the existing policy framework.

On December 8, 2001, staff met with the Argentine economic team in Washington "to advance in the specification of the size of the fiscal effort required to provide the basis" for completing the review "under the current SBA" and discussed a set of revenue-enhancing and expenditure-cutting measures that would reduce the financing gap to $10 billion for 2002–04. WHD staff commented to management that "[garnering] the support required to put in place the necessary fiscal measures would be a tall order under any circumstances, let alone the very difficult present ones." In a note to management dated December 10, FAD expressed, with broad endorsement from PDR and RES, serious concerns about the quality and credibility of that fiscal program,[49] and advised against the completion of the review on that basis, while also recognizing that further fiscal adjustment was probably not feasible.

Meanwhile, in Argentina, the flight to quality within the banking system intensified and mass demonstrations started in protest against the economic policies of the government, the deposit freeze in particular. This led to the declaration of state of emergency on December 19, and the subsequent resignations of Minister Cavallo and President De La Rúa, who would be followed by four presidents in quick succession over a period of about 10 days (see the timeline of events in Appendix 9). Management sought guidance from Directors representing the G-10 countries. A consensus emerged that the IMF would have to wait until there was a new government with whom talks could be initiated toward finding a comprehensive medium-term solution, including a plan to recapitalize the banking system. No specific proposals appear to have been discussed regarding key policy options, although there was a general debate on exchange rate regime options facing the authorities, namely, floating or devaluation accompanied by dollarization.

On its part, staff had begun outlining in some detail the main elements of a program that could be supported by a new three-year SBA, which involved further financial support from the official community. The main elements of the envisaged program included: a changed exchange rate regime (devaluation and dollarization or float); a combination of permanent fiscal adjustment and debt relief to make the public finances sustainable over the medium term; an agreed strategy to strengthen the banking sector, including phasing out withdrawal restrictions; structural reforms to support fiscal adjustment; and financial assistance from the international community to augment international reserves, restore confidence and, in the event of dollarization, provide liquidity assistance to the banking system. Specific measures were spelled out in each of these areas.

On December 23, President Rodríguez Saá, the second president to follow Fernando De La Rúa, declared partial default on Argentina's external debt. In early January 2002, President Eduardo Duhalde, the fourth president, terminated the convertibility regime and replaced it with a dual exchange rate regime consisting of a fixed rate of 1.40 pesos to the

[49]FAD noted in particular that the program being negotiated included ambitious assumptions about GDP growth, tax administration gains, revenue elasticity, and the sustainability of the drastic cuts in wages and pensions over the medium term.

dollar for foreign trade and a free market exchange rate. Immediately thereafter, the IMF dispatched a senior staff member to Buenos Aires to inquire about the authorities' immediate intentions and to communicate to them that, in order to start discussions on a new IMF-supported program, more work and better definitions would be needed in four areas: the new exchange rate regime (emphasizing that the IMF could not support the dual exchange rate system), the budget, the cost of bank restructuring, and the modality and status of phase II of the debt exchange. These elements were then refined in a confidential letter from the First Deputy Managing Director, which subsequently appeared in the Argentine press.[50]

These developments were discussed at an informal meeting of the Board on January 11, 2002, when Directors endorsed—ex post—management's initiatives and expressed a strong willingness to support Argentina. Several Directors encouraged staff to get into negotiating mode immediately, in order to avoid a vicious circle of waiting, seeing the economic situation deteriorate further, and chasing a moving target in designing a new program. Notes from staff to management indicate a keen awareness of that risk, emphasizing the authorities' lack of preparedness to deal with the situation, their general overoptimism, and the fact that they appeared to be "thinking their way through issues as they came along." In practice, however, the political reality left little choice but to wait for the authorities to make their own decisions. As it turned out, the policy decisions made in the two weeks that followed, without consultation with the IMF, including especially that of converting dollar-denominated bank assets and liabilities into pesos at asymmetric rates, inflicted irreversible damage to the banking sector and practically ensured that the worst possible scenario would materialize, as no new program could be agreed upon until a year later.

Overall assessment

By December 2001, it was clear to most observers that a devaluation of the peso and a comprehensive—NPV-reducing—debt restructuring could not be avoided, and no program could be sustainable as long as the Argentine authorities were unwilling to consider these options. Under these circumstances, the decision not to complete the review was well founded. However, it is relevant to ask whether the disengagement could have been managed better to contain the ultimate impact of the crisis.

As noted earlier, the analytical work done by the Argentina Task Force in July 2001 had predicted with striking accuracy how the crisis would unfold. Staff knew well that, unless the incumbent authorities could somehow be persuaded to handle the crisis preemptively, an all-out crisis would unfold in an environment of political dislocation and might lead to policy missteps that could aggravate the costs even further. Yet, in the face of intensifying social and political instability, the IMF did not develop an alternative approach and insist that such options be discussed with the authorities. Discussions with a member of the management team reveal that the IMF repeatedly informed the Argentine authorities that they should develop an alternative, but it did not itself produce a comprehensive alternative that could be supported with additional financing.

The result was that the crisis eventually developed as predicted. Frank assessments in internal memorandums clearly indicate that, by the end of October 2001, management and staff were convinced that completion of the fifth review would be highly unlikely under the existing terms. However, this view was not communicated clearly to the authorities, allowing them to engage in desperate attempts to save what was by then clearly unsustainable, instead of facing reality and working with the IMF toward addressing the problem in the least damaging way. Following the decision not to complete the review, the IMF did not have a meaningful impact on the critical choices made in the immediate aftermath of the termination of the convertibility regime. A workable contingency plan that could be used in support of Argentina during the painful regime shift might have produced a less traumatic outcome. The costs of the crisis would still have been huge, but earlier discussions of various exit options might have reduced the risks of policy choices that made a bad situation worse.

The Decision-Making Process

Our review of the IMF's decisions on Argentina in 2001 reveals certain features of decision making under uncertainty which, although specific to this particular episode, are also capable of generating lessons for the IMF's decision-making process. We consider below five aspects of this process: (i) internal staff organization for crisis management, (ii) contingency planning, (iii) relationship with the

[50]According to the press reports (as well as the reference made in an informal Board meeting), the letter appears to have emphasized five prerequisites for successful program negotiations: (i) a unified exchange rate in place or, alternatively, a road map toward unifying the exchange rate regime; (ii) a credible anchor for monetary policy; (iii) a credible fiscal policy—including a reform of fiscal relations between the federal government and the provinces; (iv) a clear road map with regard to bank and corporate restructuring; and (v) an agreement with a majority of the creditors about debt restructuring, bearing in mind the need for equity of treatment.

authorities, (iv) management of financial risk, and (v) Executive Board involvement.

Internal staff organization for crisis management

In the second half of 1999, the IMF geared up to crisis management mode by setting up an "Argentina Task Force," consisting of senior staff from key departments (WHD, PDR, FAD, MAE, and RES) charged with the task of overseeing the production of all relevant analytical work related to Argentina. Between July 1999 and December 2001, the task force oversaw the production of more than 40 analytical notes, largely focused on exploring the implications of alternative policy frameworks for Argentina. Late in 2000, a daily reporting process was initiated to monitor key economic and financial indicators. This was initially staffed by PDR personnel for internal departmental purposes, but was subsequently broadened to incorporate inputs from WHD staff, with output disseminated to senior staff across departments. Moreover, the First Deputy Managing Director was closely involved in all work related to Argentina.

These arrangements ensured that (i) relevant expertise from throughout the institution was brought to bear on the critical issues at stake and (ii) a lively interdepartmental debate took place on all issues, with differences of view being aired and brought to management's attention in a transparent manner.[51] While the setup of these arrangements was fully appropriate, the process nevertheless failed in two important ways. First, some critical issues only received limited attention, including whether the country faced a liquidity or a solvency crisis, whether the exchange rate was sustainable, and most importantly what practical steps to take should the preferred strategy fail. Second, the IMF never came to closure on issues that were subject to heated internal debate, such as the assessment of the merits of the mega-swap or, more critically, the type of exchange rate regime to promote as a replacement to the currency-board-like arrangement.

Contingency planning

Contingency planning, namely planning on an alternative course of action in case the current strategy failed, should be a critical element in crisis management. Such contingency planning, in a crisis context, must involve four components: (i) determining the alternative policy framework that should be adopted by the authorities if the current strategy is to fail; (ii) determining the practical steps that should be taken by the IMF and the international community in support of that strategy to maximize its chance of success and minimize its costs to the country; (iii) determining the basis upon which failure of the existing strategy and a need for change in approach should be identified before a full-blown crisis materializes; and (iv) effectively conveying this assessment to the authorities. The IMF devoted significant analytical resources to considering different contingencies (focusing for the most part on the first component), but the other, more practical elements of contingency planning were not undertaken in a meaningful way until very late in the process.

The analytical work that was done in identifying alternative courses of action for the authorities did produce an increasingly rigorous and insightful output from late 2000, but it had limited operational value for decision making for three reasons. First, the most important component of contingency planning—determining the practical steps that the IMF and the international community should take in the event the current strategy failed—was not undertaken until December 2001, when the outbreak of a full-blown crisis was all but certain. Second, even when the staff began a rigorous analysis of the viability of the current strategy and how the crisis might unfold, it did not explore possible "stop-loss rules" for the IMF sufficiently ahead of time. Third, most critically, these analyses were not shared with the authorities nor, for the most part, with the Board. In the case of the authorities, this reflected a natural reluctance to discuss any alternative strategy involving debt restructuring or a change to the exchange rate regime. In the case of the Board, it appears to have reflected concerns that candid discussions of alternative strategies might leak and hence trigger a self-fulfilling crisis.

The IMF's analytical efforts appear to have been hampered by excessive deference to the strong ownership by the authorities of the exchange rate regime and the conclusion, known even from preliminary analyses undertaken as early as 1999, that the risks and costs of abandoning the convertibility regime would be enormous. Likewise, reflections on meaningful debt restructuring scenarios were to a large extent hindered, until the late spring of 2001, by the recognition that any "coordinated" operation would likely trigger a run on banks and force a change in the exchange rate regime.[52] Despite the Prague

[51]While opposing views were sometimes held along departmental lines on some issues (e.g., the mega-swap of June 2001), the dividing line on the most fundamental aspects of diagnosis (e.g., currency overvaluation) and actions required (e.g., completion or noncompletion of a review) more frequently ran between individual staff members *within* each department.

[52]The experience in Uruguay in 2002 would later show that this premise was not necessarily correct.

framework of September 2000, little progress had in fact been made in suggesting a practical modality for involuntary PSI and the role the IMF should play in the process. There were some precedents—Russia, Ukraine, and Pakistan—but a majority of IMF staff at the time believed—perhaps with some justification—that the Argentine situation was so unique because of the magnitudes involved as to make previous experience inapplicable. More important, the absence of a clear modality to make the Prague framework operational meant that the IMF did not take a proactive role. While each debt crisis is unique and none of the precedents provided a ready-made modality for Argentina, the magnitude of the stake in Argentina would seem to have warranted greater creative thinking and proactivity on the part of the IMF using previous experience as a point of departure (as indeed was subsequently done in the case of Uruguay in 2002).

Relationship with the authorities

Whereas in the first year of the SBA the authorities had designed economic policies in close coordination with IMF staff, the relationship became somewhat uncooperative from May 2001 onward. First, the Minister of Economy developed a pattern of taking policy initiatives unforeseen by—and often incompatible in spirit with—the program negotiated with the IMF, without prior consultation (Box 3.3). Second, staff found it all but impossible to have a substantive interaction with the authorities regarding contingency plans until the late summer or fall of 2001.[53]

Three factors seem to explain why the IMF accepted such an ineffective relationship with the country authorities.

- First, the IMF, after being widely criticized in the aftermath of the East Asian crisis for imposing its will on member countries, was keen to promote country ownership of programs in every possible way. The Argentine program was unquestionably fully owned by the authorities[54] and in the climate of the time, this was perceived as a source of strength. Mindful of the credibility of its general pro-ownership message, the IMF thought that it could ill afford to criticize such a highly owned program.
- Second, both management and the Board feared above all that lack of public endorsement for the measures announced by the authorities might, in itself, trigger a confidence crisis. This implies a belief that the markets would see the measures under a less negative light if the IMF appeared to endorse them. However, feedback obtained from market participants in the course of interviews conducted by the evaluation team found no evidence that this was indeed the case. On the contrary, market participants were puzzled by the IMF's reaction.
- Third, management and Directors seemed to have entertained the hope that strongly worded statements at the Board or in occasional direct exchanges with the authorities would suffice to persuade them to mend their ways. While this hope was not inconsistent with standard Board practice, it clearly lacked realism in this case.

Management of financial risk

By January 2001, the IMF had increased its exposure to levels where Argentina's capacity to repay was clearly in question.[55] Nevertheless, the IMF continued to make decisions to commit additional resources to the point where exposure to Argentina became alarmingly large, without regard for the financial risk it was assuming. Concentration of credit risk is to some extent inevitable for a crisis lender such as the IMF, and part of this risk is protected by the seniority of IMF credit. Even so, there was a general lack of focus on financial risk within the IMF,[56] which resulted in a failure to bring relevant expertise to bear on the critical decisions being made. In particular, no staff from the Treasurer's

[53]It was only after September 2001 that some exchange of views on alternative strategies began to take place at the working level. The Minister of Economy himself, however, did not become involved in such discussion until November, by which time the quality of the dialogue had deteriorated even more. A good amount of communication was thus effected through formal letters, with the Minister of Economy repeatedly urging the Managing Director to send a staff mission and the Managing Director writing to the Argentine President to explain why he would not do so. The deterioration in the quality of dialogue between the two parties in part reflected the widening perception gap as to what constituted the next steps.

[54]Strong country ownership, however, masked increasingly sharp dissentions within the Argentine economic team as the crisis intensified.

[55]In comments written earlier in January 2000 on the program design for the March 2000 SBA, TRE had noted that "Argentina's capacity to repay the Fund is of primary concern, given the projected increase in external borrowing requirements and the high level of external debt service (in percent of exports)." This comment applied to the commitment of only SDR 5.4 billion (compared with SDR 17.5 billion following the second augmentation).

[56]There was a sharp increase in the number and volume of arrears to the IMF in the second half of the 1980s, leading to the adoption, in the early 1990s, of strengthened due diligence procedures in assessing members' capacity to repay the IMF. These procedures contributed to a sharp decline in both the number and volume of arrears by the late 1990s when, as noted in the IEO report on prolonged use of IMF resources (IEO, 2002), assessments of capacity to repay became pro forma exercises.

Box 3.3. Measures Announced or Taken During 2001 Without Prior Consultation With the IMF

March 28. Minister Cavallo announced an economic program consisting of a tax on financial transactions, changes in other taxes and tariffs, and sectoral "competitiveness plans."

April 9. Banks were allowed to include government securities up to Arg$2 billion to meet the liquidity requirements.

April 16. Minister Cavallo sent to Congress a bill to modify the convertibility law to change the anchor to an equally weighted basket of the euro and the dollar.

May 2. Minister Cavallo proposed a "mega-swap," under which investors would exchange maturing bonds for new bonds with longer maturities.

June 15. Minister Cavallo announced a package of tax and trade measures, including a trade compensation mechanism for exporters and importers of nonenergy goods, which effectively amounted to a devaluation of the peso through fiscal means.

July 11. Minister Cavallo announced a "zero-deficit plan," aimed at eliminating the federal government deficit from August 2001 onwards.

November 1. The authorities announced a new package, including a debt exchange, a new batch of competitiveness plans, a rebate of VAT payments on debit card transactions, and a temporary reduction in employee social security contributions.

November 23. The central bank introduced an effective cap on deposit rates, by imposing a 100 percent liquidity requirement on deposits paying an interest rate more than 1 percentage point above the average of all local banks.

December 1. The authorities introduced wide-ranging controls on banking and foreign exchange transactions, including setting a weekly limit of US$250 on withdrawals from individual bank accounts, prohibiting banks from granting loans in pesos, and introducing foreign exchange restrictions on travel and transfers abroad.

(now Finance) Department was included in the work of the Argentina Task Force.[57]

Risk analysis, if undertaken ahead of the January 2001 augmentation, would have indicated that the IMF's overall liquidity position would for an extended period of time remain highly exposed to Argentina, in terms of both outstanding credit and projected charges. In the event of a nonpayment of principal, the IMF's precautionary balances would not be sufficient to cover the total amount of arrears that could arise, with concerns for the capacity of the current burden-sharing mechanism to make up for the resulting loss of income. Argentina's risk was exceptional, not only in the size of the amounts involved, but also in the length of time the IMF's exposure would be likely to remain high.[58]

The fact that risk analysis was not prepared by staff, much less shared with the Board, probably contributed to the lack of noticeable concern on the part of many Directors about the financial risks that greater exposure to Argentina would pose. It is still striking how few Directors raised this issue as a concern during Board discussions, especially given the lack of conditionality on net international reserves (in view of what was considered to be a functioning currency board arrangement) and, in September 2001, the absence of standard assurances in the staff report concerning Argentina's ability to repay the IMF.

Executive Board involvement

The Executive Board was extensively involved in dealing with the Argentine situation. In addition to formal Board meetings to approve program reviews, the Board met informally to discuss Argentina on 16 occasions from December 2000 to January 2002. Yet, in practice, the Board as an institution played a limited role in providing inputs, not just into the specifics of program design (as is customary), but also in the overall strategy on Argentina. This assessment, however, may not apply to some individual Directors or subgroups of Directors, as they may have been privy to exchanges between management and their authorities outside the established internal channels. The focus here is on the formal role of the Board within the established decision-making procedures of the IMF.

There were several reasons for the limited role the Executive Board played in considering alternative

[57]TRE had an opportunity to express any reservations it might have had on financial risk grounds through the normal review process. Until very recently, however, its concurrence was not required for briefing papers, LOIs, and other documents to be submitted to management, so that any reservations it might have expressed could have been of limited force. In any event, no such reservations were expressed by TRE in 2001 through the established procedure.

[58]Such analysis was made in September 2003 in a report to the Board prepared jointly by PDR and the Finance Department (FIN). This analysis reached broadly the same conclusion as expressed here.

strategies when faced with decisions concerning Argentina. First, the Board generally had very limited lead time, if any, to consider matters subject to its decision, in part because of the fluidity of the situation, but also because management in most cases convened a Board meeting only at a late stage of the decision-making process and insisted that a public statement indicating the broad thrust of the decision be released immediately after the meeting. This was the case in both augmentation decisions (in December 2000 and August 2001), as well as on several occasions when management felt compelled to take a stance on a particular policy announcement of the authorities in the spring and summer of 2001. Directors expressed reservations about the process but went along with it. In the critical decision not to complete the fifth review under the existing terms, although the decision was taking shape through the month of November, the Board was only informed on December 5, the same day as the public, having received only scant indications before that day that this decision was in the making.

Second, a majority of the Board appeared willing to accept a "take it or leave it" decision process, whereby the only choice available was to endorse management's proposal or take responsibility for triggering a financial crisis. Such a setting inevitably tilts the decision in favor of supporting the country almost irrespective of the odds of success of the proposed strategy. A process whereby the Board is given a choice among several strategies for supporting a country would have likely yielded a more balanced outcome. The only occasion where such a choice was presented was in August 2001 when the Managing Director indicated that the Board had to choose between three options. However, the pros and cons of these options were not analyzed in any depth and the only option presented in some detail was management's preferred option.

Third, a majority of the Board also appeared willing to leave important questions unanswered. Executive Directors, for example, seldom asked such critical questions as "What would be the exit strategy for the IMF?" or "Is there a contingency plan if the current strategy does not work?" Notably, Directors did not take advantage of the usual lapse of time between public announcement and formal Board approval in order to improve the robustness of the decision, for example, by requesting greater safeguards to IMF resources or further analytical work from staff. It is true that at each formal Board meeting several Directors did inquire about contingency plans. But each time, management's response was that work was ongoing at the staff level and that, in view of the sensitivity of the matter, it would be best not to discuss such options at the Board. As it turned out, the work under way only partially addressed the relevant issues, but when the Board learned of the work, it was already too late.[59]

Fourth, when staff reports were less than fully candid about the prospects and risks involved, as was the case for most of the decisions taken in 2001, Executive Directors inevitably had less than a firm basis for demanding answers to the most critical questions.

Finally, inherent asymmetry in the process necessarily limited the ability of the Board to exercise strict oversight in the December 2001 decision: when the Managing Director decides not to complete a program review, Board acquiescence is not formally required.[60] As noted above, in the Argentine case, management did not involve the Board in the process of coming to this decision.[61]

Some have argued that these weaknesses in the Board oversight of management decisions reflect an inherent conflict of interest for most Executive Directors. Those representing borrowing countries tend to show solidarity with other borrowers and are reluctant to challenge management lest it jeopardize their chance of receiving its support should it be needed. Those representing major industrial countries necessarily work within the parameters determined by the positions taken by their authorities outside the Board in their direct interaction with management. Reluctance to discuss highly sensitive issues in the Board, where there is a risk of leaks, is understandable. Nevertheless, bypassing the Board undermines its governance function, and weakens the transparency and accountability of the decision-making process in the IMF.

The extent to which decisions on critical program issues are taken solely within the Board, and on the basis of full information and participation by all Board members, is one of the key governance issues of the IMF. The IMF's shareholders are sovereign governments and it is inevitable, and also not improper, that they will make their views known to management. This is bound to condition management decisions when the shareholders concerned represent or can mobilize a majority. Documents

[59]At the Board meeting on the third review of the SBA, in May 2001, no Director reacted even when the staff representative admitted that "within the present monetary and exchange rate system, there is no contingency plan."

[60]Legally, the Board may decide to complete a program review even if the Managing Director does not recommend it, and Board members could in theory take the initiative to place the decision on the Board's agenda and put it to a vote. In practice, this has never happened.

[61]An "informal restricted Board meeting" was held to discuss Argentina on November 2, 2001, while the decision was still in the making. Informal minutes of the meeting indicate that management's view on whether or not to complete the fifth review was not discussed.

available to the IEO provide no indication of the extent to which this happened in the case of Argentina. However, a wide range of staff members and others interviewed believe that decisions on Argentina were influenced by external pressures.[62] But it is not easy to determine what constitutes such pressure or whether it is inappropriate. As noted above, expectations that had formed among market participants did constrain decision making in the IMF. As to political pressure, it is difficult to define. Certainly, the mere expression by a shareholder government of its preferences cannot be called political pressure, and the key issue is whether management took decisions on its own responsibility. Those in management who were involved have indicated to the IEO that they made all critical decisions under their purview with full responsibility whatever the wishes of the major shareholders.

[62]For instance, the internal review of the role of the IMF in the Argentine crisis states that the "IMF yielded to external political and market pressures to continue providing its support, despite serious concerns over fiscal and external sustainability" (PDR, 2003, p. 72).

Chapter 4

Lessons from the Argentine Crisis

This concluding chapter draws on the previous two chapters to summarize the major findings of the evaluation, and presents ten lessons for the IMF that are suggested by these findings. The chapter then concludes with six sets of recommendations.

Major Findings

The major findings of the evaluation are summarized below, organized by (i) overview of the crisis; (ii) surveillance and program design in the precrisis period; and (iii) crisis management.

Overview of the crisis

The catastrophic collapse of the Argentine economy in 2001–02 represents the failure of Argentine policymakers to take necessary corrective measures at a sufficiently early stage. The IMF on its part, supported by its major shareholders, also erred in failing to call an earlier halt to support for a strategy that, as implemented, was not sustainable. As the crisis deepened, the IMF was not able to engage the authorities in evolving an alternative strategy that might have helped mitigate the ultimate costs of the crisis, even though these would have been inevitably high.

The convertibility regime was an effective response to the economic reality of the early 1990s, when a decade of economic mismanagement had shattered the public's demand for local currency. However, its success in ending hyperinflation, facilitating a strong recovery in the early 1990s, surviving the Mexican crisis of 1995, and promoting strong growth in 1996–98 masked the regime's potential medium-term vulnerabilities. There were favorable factors that allowed the exchange rate regime to survive for a number of years without being severely tested. The situation changed in 1998–99 when Argentina was hit by a series of adverse shocks, including the devaluation of the Brazilian real, a sharp reduction in capital flows to emerging markets, a strengthening dollar, and a rise in international interest rates, which, taken together, led to a permanent decline in Argentina's equilibrium real exchange rate.

These shocks would have been difficult enough to handle at any time, given the rigidity of the fixed exchange rate and the lack of downward flexibility in domestic wages and prices. As it happened, they came at a time when the fiscal situation had deteriorated steadily, with a continuous rise in the balance of public debt. What is worse, almost 90 percent of the debt was denominated in foreign currencies, raising doubts about Argentina's debt servicing capacity and exacerbating the vulnerability to shifts in equilibrium real exchange rates. The resulting rise in sovereign spreads, in an environment where growth remained low, created highly unfavorable debt dynamics. The domestic political situation also contributed to how the crisis evolved, as the election-driven rise in public spending in 1998–99 added to fiscal fragility and the divisions in the coalition government that took office in late 1999 shook the confidence of domestic and international investors in Argentina's ability to take difficult decisions.

By late 2000, when the ongoing recession and internal political discord had caused Argentina effectively to lose access to international capital markets, Argentina had both an exchange rate problem and a debt sustainability problem, but it lacked the political cohesion to deal with the situation with decisiveness. The IMF sought to assist Argentina through an augmentation of the SBA in January 2001, based on the assumption that the crisis was largely a liquidity crisis and that any debt sustainability or exchange rate problem was still manageable. It was thought that official financing, combined with sufficient action on the fiscal front, would catalyze private flows relatively quickly and restart economic growth.

The January 2001 program was therefore optimistic to begin with and, as it happened, the commitments made under the program were not fully implemented. In particular, it soon became evident that the fiscal targets would not be met. The willingness of the IMF to complete a review in May 2001 despite Argentina's noncompliance with fiscal targets, when there were indications that the catalytic approach had failed, allowed the authorities to pursue a

series of desperate and unorthodox measures to "gamble for redemption." Many in the IMF internally expressed disagreement with those measures but, in public, the IMF supported Argentina,[1] fearing that doing otherwise would mean an immediate explosion of the crisis. A further augmentation of the SBA was approved in September 2001, accompanied by ineffective and conceptually flawed efforts to promote a voluntary debt restructuring without offering a sustainable policy framework. This did not restore market confidence and only allowed the crisis to drag on.

In retrospect, the IMF's efforts at crisis management suffered from a serious weakness. At each decision point in 2000–01, the IMF's management and Executive Board considered the costs of a switch, from a less sustainable policy environment to one that would be more sustainable in the long run but that would involve massive disturbances in the short run, to be too high, and chose to buy time until conditions improved. The costs of an exit would have been very large indeed, regardless of when it was made. As it turned out, the ultimate costs probably rose, as Argentina's credibility was lost, international reserves declined further, more public debt was forced on the banking sector and more deposits were withdrawn, and the country's debt to the IMF expanded against the background of falling output.

The objective of the strategy followed in 2001 was to minimize the costs of the crisis, not only to the Argentine economy, but also to the international financial system and the IMF. Contagion from Argentina was indeed limited, but it is impossible to state with any certainty whether the lack of contagion was a direct outcome of the way in which the Argentine situation was handled by the IMF. It seems plausible, however, that the protracted nature of the Argentine crisis—and the fact that it was in the end widely anticipated by market participants—was the major factor explaining the lack of wider contagion. The costs to the IMF, however, were sizable. Its financial support inevitably linked the IMF in the view of the public with the unorthodox policies followed by the authorities; its repeated willingness to support such policies and to stretch the use of discretion beyond established access limits gave rise to a perception that it lacked evenhandedness in dealing with member countries.[2] The concentration of the IMF's own credit risk also increased, although this was to some extent unavoidable for a crisis lender such as the IMF. Last but not least, any catalytic role that IMF financing might have had in the past has been put into question, as large-scale IMF support can no longer be seen as signaling policy sustainability.

[1] At the time of the April 2001 IMFC meeting, for example, the Managing Director stated: "We do think that Minister Cavallo's approach, particularly with the competitiveness law, is right." See transcript of the press conference, April 27, 2001.

[2] These views come from personal interviews, including with IMF staff and some Executive Directors who directly encountered such sentiment expressed by country authorities. The evaluation team cannot ascertain how widely these views are held.

Surveillance and program design in the precrisis period

The IMF played a constructive role in the first half of the 1990s, when its support gave credibility to Argentina's stabilization and structural reform efforts. Although the IMF was initially skeptical as to whether the convertibility plan would work, it supported the authorities' commitment to pursue supportive policy measures with two successive financing arrangements. *The IMF correctly identified the potential vulnerabilities inherent in the convertibility regime for a country like Argentina and the need for fiscal discipline and labor market flexibility as essential to the maintenance of the convertibility regime. The IMF pushed for corrective actions in both its surveillance activity and program design, but these efforts had mixed success and their impact declined over time as political commitment to the necessary adjustment waned.* The IMF also provided technical assistance in support of structural fiscal reforms, including improved tax administration. This support proved to be justified in the earlier years, as the political system was able to deliver substantially improved fiscal performance.

However, there were weaknesses in the IMF's fiscal analysis during this period. Fiscal performance was overstated, because of the failure to take proper account of off-balance expenditures, while it underestimated the adverse fiscal implications of the social security reform. One of the missing pieces was the provincial finances. Data limitations and legal constraints prevented the IMF from pressing for greater fiscal discipline and structural fiscal reforms at the provincial level. These deficiencies were understandable, given the existing professional knowledge, available analytical tools, and data limitations. The IMF's high stake in Argentina, however, should have prompted the staff to explore in greater depth the consequence for debt sustainability that might arise from considerably less favorable economic developments.

In the years following the Mexican crisis, the IMF's approach seemed to change. While continuing to emphasize the importance of fiscal adjustment and structural reform, the IMF repeatedly overlooked weaknesses in these areas. A number of waivers were granted for nonobservance of fiscal performance criteria, and past nonperformance was

accommodated by letting off-track arrangements expire and replacing them with new ones, when the correct response should have been to end the program relationship with Argentina. Taken together, *this series of decisions allowed the authorities to postpone needed policy measures, while linking the credibility of the IMF to the policies that were inadequate to the task at hand.* Moreover, the IMF, instead of emphasizing the policies needed to make the chosen exchange rate regime viable, began to endorse the exchange rate regime itself. Indeed, the IMF publicly lauded convertibility as an example of a currency board, the only type of fixed exchange rate regime that is fundamentally sustainable in a world of high capital mobility.

The Argentine experience illustrates the problems posed by strong country ownership of weak or inconsistent policies. All of the key economic policy decisions of the convertibility era were initiated by the Argentine authorities. These included the choice of the currency-board-like arrangement, the comprehensive program of deregulation and privatization, and far-reaching financial sector reforms. The problem was that, while all of the major political figures stated their endorsement of the fixed exchange rate policy, *the political consensus behind the necessary supporting policies in the fiscal and structural areas became progressively weaker over time*. As early as 1993, political resistance had led to a significant modification of the social security reform, which raised fiscal deficits instead of eliminating them. Labor market reform was initiated in 1991, and then repeatedly postponed. From 1996 onward, and particularly in 1999, electoral competition led to a weakening of fiscal discipline at the federal and provincial levels and the stalling—and rolling back in some cases—of the pace of structural reform. All these developments should have provided ample reason for the IMF to end its program relationship with Argentina.

In the face of an increasingly inconsistent policy mix, the IMF did not press for a modification of the exchange rate regime until it was too late. A modification of the peg was politically difficult and advice to this effect may not have been accepted. *In retrospect, it would have been better to have pushed for such a change much earlier in the 1990s. A clear position on the need for exit would have shaped subsequent exchanges with the authorities*. Even after the onset of the crisis in 2000, the IMF's strategy remained essentially unchanged. This reflected two factors:

- The IMF's culture discouraged questioning a member country's choice of exchange rate regime, despite the fact that, from the late 1990s, guidance to staff increasingly stressed the importance of providing candid advice to member countries on exchange rate policy in the context of bilateral surveillance.[3]
- The IMF lacked a forward-looking concept of exchange rate sustainability and failed to use the best analytical tools. At most, staff looked at standard measures of the real exchange rate based on past price developments, and came to the conclusion that the real exchange rate was at most moderately overvalued by the end of the 1990s. But a deeper and more systematic analysis of the conditions facing Argentina would have led to the conclusion that, in 2000, Argentina's fixed exchange rate could not be sustained for long.[4]

Throughout the period, different views were articulated within the IMF by different individuals and across different parts of the institution. Some review departments, as well as some individual members of the staff and Executive Board, expressed concerns over Argentina's inability to deliver the needed fiscal discipline and structural reforms at different points in time. Almost always, these dissenting views were overruled by such considerations as the need to maintain influence with a member country or a desire to preserve the catalytic effect of the IMF's seal of approval. Supporting a weak program while maintaining influence was thought better than insisting on a strong program that was unlikely to be implemented, leading to suspension of support and an eventual loss of influence.

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[3]An attachment to the Board document on its biennial review of surveillance conducted in early 2000 stated that "the Fund should strive to provide clear advice to members on their choice of exchange rate systems . . . and continue, in the context of Article IV consultations, to discuss with the authorities the requirements for making a chosen exchange rate regime function reasonably well in the particular circumstances of that country and to actively advise on the suitability of the exchange rate regime." It further noted that [Directors] "encouraged the staff to collaborate at an early stage with countries using pegs in designing [appropriate] exit strategies." See "Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision," SM/00/40, February 2000, pp. 89–92.

[4]These conditions included: (i) the observed real appreciation over the 1990s; (ii) the series of adverse shocks that had hit the economy since late 1998; (iii) the small tradable goods sector (requiring a larger real depreciation for a given external shock); (iv) the large resource gap between the persistent trade deficit and the significant surplus needed to stabilize the external debt-to-GDP ratio; (v) the large external debt-to-exports ratio; (vi) the existence of a structural and persistent current account deficit (with the current account remaining in deficit even during a deepening recession); (vii) the weak dynamics of exports while imports were growing faster; (viii) the deepening recession; (ix) the deflation required to achieve a painful change in relative prices; (x) the contraction of the import competing sector; and (xi) the market signals that showed large and increasing forward premia pointing to increasing investor expectations that the exchange rate could not be maintained for long.

Crisis management

The January 2001 decision to augment Argentina's Stand-By Arrangement contained several weaknesses. While the probability that Argentina's debt and exchange rate were sustainable was judged sufficiently high to warrant giving the country a chance to attempt the "catalytic" approach, this judgment was not based on rigorous debt and exchange rate sustainability analysis or a careful examination of various indicators, many of which were indicating worrisome signs. Program design was appropriate for the policy challenges only under the assumption that Argentina was facing primarily a liquidity crisis, albeit one that required some significant policy correction but within the confines of the existing policy regime. *It may be argued that the decision was justified as long as the probability of success was not negligible—which makes it difficult to conclude that it was clearly wrong ex ante. Even so, such a decision should have included an exit strategy in case the assumption proved wrong and therefore the preferred strategy failed.*

It is possible that the January 2001 decision, with all its flaws, may have succeeded in restoring confidence if the assumptions about the external economic environment had proved correct (which they were not) and the agreed program had been impeccably executed by the Argentine authorities (which it was not). However, subsequent developments should have led to an early assessment that the approach had indeed failed and further augmentation of IMF resources with essentially the same framework was unlikely to achieve much except buying a little more time. By the spring of 2001, even the modest fiscal adjustment envisaged in the program had not been achieved. Two Ministers of Economy had resigned and the governing coalition was visibly weakening; the new economic team was engaged in a number of highly controversial and increasingly desperate policy actions that were eroding, rather than strengthening, market and investor confidence; and the central bank governor had been replaced ostensibly for political reasons, undermining central bank independence.

The decisions to complete the third review in May 2001 and, even more, the subsequent decision to further augment the arrangement in September 2001 were questionable in view of the spirit—if not the letter—of IMF policies on crisis financing. In particular, the IMF contravened its stated policies on private sector involvement and the Supplemental Reserve Facility, because its support was not based on a fundamental diagnosis of sustainability. The program design supported by each of these decisions was inadequate for resolving the crisis. Several rationales were given for these decisions, including in particular the perception of a lack of credible alternatives; deference to the authorities' determination to succeed; and fear of contagion and concern that the IMF might be seen to cause the demise of a member in distress.

The IMF was unduly reluctant to press for a change in the exchange rate regime because the peg was seen to be strongly owned by the authorities and also still commanded wide public support in Argentina. External criticism of the allegedly intrusive conditionality imposed on the East Asian crisis countries had led the IMF to show excessive deference to the authorities' ownership of policies that it knew were misguided and counterproductive. At the same time, the IMF failed to draw the appropriate lesson early enough from the crises in East Asia, Russia, and Brazil, namely that in these cases the catalytic approach worked only after the fixed exchange rate regime had been abandoned (see Lesson 7 below).

Available analytical tools were not used to explore potential vulnerabilities in sufficient depth. In addition to the already-mentioned failure to use forward-looking tools to assess exchange rate sustainability, debt sustainability analysis was not performed rigorously.[5] The debt path should have been subjected to stress testing for different assumptions about primary balances, real interest rates, growth prospects and, most importantly, the exchange rate.[6] The IMF thus lacked an objective basis to argue for a fundamental modification of the policy framework—through devaluation, debt restructuring, or most likely both—and to impress this assessment on both the authorities and the shareholders. These factors continued to tie the hands of the IMF through the summer of 2001, when market signals, including forward premia that reached 40 percent, were sending an unambiguous message that the exchange rate was unsustainable.

Contingency planning was inadequate, in part because of the authorities' unwillingness to discuss alternatives should their preferred strategy fail. While considerable staff resources were dedicated throughout 2001 to determining what would be the best alternative exchange rate regime, how much debt relief would be desirable, and what the anatomy of an eventual crisis might look like, these efforts did not focus on producing plans for an alternative policy framework that might have involved a move to a different exchange rate regime and a coercive re-

[5]Staff indicated to the evaluation team that it had used such analyses in formulating its judgments on Argentina, but no written evidence of this exists in any of the internal memorandums or notes supplied to the IEO, let alone in the staff reports.

[6]A conjecture on whether tools now in place would have sent clear warning signals is offered in Appendix 6.

structuring of the debt. The alternative would have been costly, but the collateral damage could have been lowered if the switch had been attempted earlier and if IMF resources had been made available. Production of such operational plans would have required greater in-house analyses and deeper collaboration with the authorities. In response to Board members' queries, management consistently indicated that it was working with staff on contingency plans, but such planning never advanced very far in light of the authorities' consistent refusal to engage in such discussions. The authorities' concern that any appearance of engaging in contingency planning would risk undermining the credibility of their commitment to their current strategy is understandable, but the IMF should have insisted on a confidential discussion of contingencies as the price of its support, including sharing with the authorities its own analytical work and assessments.

It must be recognized that any alternative plan for managing the crisis would also have entailed large costs, even in a best-case scenario, and there is no assurance that it would have received the needed backing of a majority of shareholders and the cooperation of the authorities. But the fact that no such discussion ever took place restricted the choices facing the IMF's decision makers to either supporting an unsustainable program or abandoning a member country in distress. As a result, IMF resources were used in support of a regime that was becoming increasingly unsustainable. Instead of financing capital flight and letting Argentina endure another six months of deflation and output loss, the available resources could have been better used to ease the inevitable costs of transition to a new regime, by limiting the extent of exchange rate overshooting and minimizing the credit crunch that might result.

What might an alternative strategy have looked like? This is a difficult issue, and it may well go beyond the terms of reference of this evaluation. However, as an illustration, we discuss a possible approach in Box 4.1. As with all such counterfactuals, a key question is whether sufficient political support could have been mobilized behind such a plan, especially if it were adopted in circumstances where the IMF was likely to be accused of pushing Argentina into a crisis. In these circumstances, any alternative strategy would have had very high economic costs and was likely to have resulted in significant political disruption. An "orderly" exit was probably impossible at this stage, and even more so given the lack of political support for any coherent alternative strategy.

The IMF was thus faced with choosing between various highly unpalatable—and uncertain—alternatives. Nevertheless, greater contingency planning (with insistence on the authorities' cooperation as a quid pro quo for IMF support for their preferred strategy) might have avoided a process in which the IMF continued to support an unviable strategy until the last possible moment. This was probably more costly than would have been the case if a shift in strategy had been attempted at an earlier stage, although it is clearly not possible to predict how the Argentinean political situation would have reacted to attempts by the IMF to force such a shift. In the event, when the eventual decision to cease support became inevitable, the authorities (either incumbent or incoming) did not have a road map for handling the consequences of this decision. The political dislocation that ensued limited the ability of management and staff to engage in effective damage control discussions with the new authorities, leading to several policy decisions on the part of the authorities that deepened the crisis.

While not always provided with all the elements required for well-informed decisions, the Executive Board did not fully exercise oversight to prevent the IMF's resources from being used to support an unsustainable policy, as well as its fiduciary responsibility to protect their revolving character. In part, this reflected the fact that the Board—reluctantly in some cases—accepted a limited strategic involvement in the decisions made by management and did not receive some critical information (despite the occasional requests of a few Directors). This is the reflection of a larger problem of governance in the IMF, where important decisions are made by major shareholders outside the Executive Board and, as potential borrowers, chairs representing developing countries hardly, if ever, challenge the proposal brought to the Board by management to support a member country.

Lessons for the IMF

The Argentine experience yields a number of useful lessons for the IMF. Many of these arise from Argentina's prolonged use of IMF resources and validate the lessons drawn by the IEO's previous evaluation (IEO, 2002), which emphasized the need for periodic strategic reassessments of program achievements and of the rationale for continued IMF engagement in a program relationship. We present below ten additional lessons, some of which have already been drawn by the IMF and have led to improvements in its policies and procedures.[7] These are grouped under three broad topic areas: surveillance and program design, crisis management, and the decision-making process.

[7]See, most notably, PDR (2003). This paper was discussed by the IMF Executive Board on November 17, 2003.

Box 4.1. How and When Could an Alternative Approach Have Been Attempted?

Any alternative strategy ("Plan B") would have needed to include as its essential elements both devaluation and debt restructuring.[1] A debt restructuring without devaluation would have been neither feasible nor credible. First, the magnitude of the adverse shocks was large and the required external and relative price adjustments were substantial. Second, a coercive debt restructuring would have led to a run on the currency. Third, an attempt to avoid a change in the exchange rate regime in all recent currency crises had failed.

The main issue then would have been how to minimize the inevitable very high costs of such a strategy, including: (i) debt servicing difficulties arising from a sharp exchange rate depreciation for sectors with large foreign currency liabilities, and the resulting strains on the banking system; and (ii) the balance sheet effects on banks arising from a devaluation and an NPV reduction in the public debt. Under these circumstances, even if a standstill could stop a run on domestic debt (to be followed by debt restructuring), there would still have been a run on banks and a run on the currency, which was likely to overshoot when it was floated. These developments would have led to widespread bankruptcies, a credit crunch, and a sharp contraction of economic activity.

The order of magnitude and complications involved in Argentina were such as to make the challenges involved in devising an alternative strategy much greater than in any other case. Moreover, the political consequences of the path by which Argentina arrived at an alternative strategy cannot be ignored. Strong political leadership for such a strategy would obviously have helped reduce potential costs, but this was unlikely to be forthcoming in the situation then prevailing. Therefore, it is quite possible that a situation in which some groups in Argentina viewed a devaluation/debt restructuring as having been "forced" by the IMF would have been associated with even greater political disruptions and short-term policy choices that would have made the situation worse. In other words, there may well have been no feasible actions by the IMF that would have enabled the adoption of a meaningful Plan B. But this possibility is not an adequate justification for failing to think about, let alone design and actively promote, such a plan.

With these caveats in mind, such a Plan B may well have shared some features of the approach taken in Pakistan, Uruguay, or Ukraine, where the face value of the debt was maintained, maturities stretched, and the interest rate on the new debt capped at below-market interest rates. Even if Argentina's problems warranted a sharper debt reduction, early action would have likely entailed a smaller haircut than required when a total economic and financial meltdown had occurred. Particularly interesting as a model for Argentina is the approach taken in 2002 in Uruguay, where the IMF provided exceptional support (694 percent of quota) for the government's efforts to achieve genuine debt relief following a move to a float. In the event, the debt restructuring implemented in early 2003 achieved a 20 percent reduction in the NPV of government debt, with Uruguay remaining current on its debt payments throughout the negotiations.[2] The debt restructuring was coordinated but voluntary, and took place against the background of a comprehensive, coherent program of economic reforms that was backed by the IMF. However, creditors' willingness to adopt this approach in Uruguay was itself partly a result of developments in Argentina.

The plan should also have included a coordinated rollover of interbank lines, because the reduction in the cross-border exposure of domestic and foreign banks in 2001 was an important source of pressure on the currency and international reserves—although the greater solvency risks would have undoubtedly made such an exercise more complicated than in, say, Korea. Targeted, hence less disruptive, measures to deal with a bank run and capital flight could also have been attempted if necessary, including some restrictions on the conversion of peso deposits into dollar deposits (instead of the deposit freezes that the collapse eventually required).

Although it is impossible to test counterfactuals, the damage could have been dampened if action had been taken early and with the buffer provided by adequate official support. An earlier exit from the convertibility regime would have been less disruptive than the free fall of the currency that followed the eventual disorderly exit, with the associated severe balance sheet effects. To contain these costs, part of the IMF resources could have been used to dampen an overshooting of the peso and to support the banking system, in conjunction with a credible policy package, although it is very difficult to avoid some overshooting in such circumstances. Some capital controls may have been unavoidable, but the extent of these controls could have been kept to a much smaller and less disruptive level than those actually imposed in late 2001 and 2002, which led to severe real and financial disruptions.

It would have been difficult to know when the alternative strategy of devaluation and debt restructuring

[1]In fact, this was also the majority view eventually reached by IMF staff.

[2]It should be noted that the extent of liability dollarization and exposure of banks to government debt were smaller in Uruguay than in Argentina. A package close to 11 percent of GDP was sufficient, in the case of Uruguay, to effectively stop the run on the banks and to prevent a disorderly meltdown of the financial system while a coordinated debt restructuring and a move to a float were being implemented. Uruguay suffered a sharp economic contraction, but output began to recover during the same year that the debt exchange was completed (with GDP growing 1 percent in 2003), and a cooperative relationship with international creditors was preserved.

Box 4.1 *(concluded)*

needed to be attempted. In hindsight, an ideal time would have been when there were still ample international reserves to smooth the overshoot of the exchange rate, the balance sheets of banks and pension funds had not yet been weakened by forced purchases of government bonds, and sufficiently large resources were still available from the IMF to shore up both reserves and the banking system, thereby providing confidence in the system and limiting the extent of capital flight. These considerations suggest that the marked—though short-lived—improvement in market conditions that followed the approval of the first augmentation, in January 2001, provided the best window of opportunity. Another opportunity would have been immediately after the appointment of Mr. Cavallo as Minister of Economy, capitalizing on his international credibility and strong domestic political leadership. Even if that window was missed, such a strategy might have remained viable until late in the year and led to a less traumatic outcome than actually happened—although the costs would still have been very high.

Surveillance and program design

Lesson 1. While the choice of exchange rate regime is one that belongs to country authorities, *the IMF must exercise firm and candid surveillance to ensure that this choice is consistent with other policies and constraints*. This has been repeatedly endorsed by the Executive Board at least since 1997 but was not observed in the case of Argentina. Recent emerging market crises have shown that fixed exchange rate regimes are difficult to maintain under open capital accounts. The case of Argentina clearly suggests that this lesson may also apply to "hard" pegs, if the necessary political support is lacking for the policies needed to make the adjustment mechanism palatable in the longer term. The Argentine experience also suggests that domestic political considerations often make it difficult to change a fixed exchange rate regime, whether during good times or during bad times.[8] Therefore, exit from an unsustainable peg is usually forced by events, entailing even greater costs than would be the case if it occurred through a voluntary exit at an appropriately chosen point. Part of the problem is that the costs and benefits of alternative exchange rate regimes, especially the stringent requirements of sustaining a fixed peg, are typically not widely discussed in countries' domestic political debate. This is where the IMF can play a useful role by ensuring that a genuine policy debate takes place, in good times, about the costs and benefits of the existing exchange rate regime. This means that there must be regular in-depth discussions of the issues with the authorities, as part of routine surveillance exercises. Discussing exchange rate policy when a fixed peg is involved is inherently sensitive and can potentially alarm the markets. It is precisely for this reason that discussion should be made a routine exercise, something the markets expect to occur as a matter of procedure.

Lesson 2. The level of sustainable debt for emerging market economies with open capital accounts may be lower than had been thought, depending on a country's economic characteristics. Argentina's experience exemplifies the proposition that is now well recognized in the IMF, namely that "debt intolerance" in many emerging market economies deserves special attention and that the conduct of fiscal policy should therefore be sensitive not only to year-to-year fiscal imbalances, but also to the overall stock of public debt. As has been noted by IMF staff (Reinhart and others, 2003; IMF, 2003; and PDR, 2003), a stock of debt that otherwise looks reasonable relative to other countries may be too high, when account is taken of the currency of denomination, the country's openness to trade, the revenue base, the fiscal flexibility of the government, its past record of default and inflation, and the role assigned to fiscal policy in macroeconomic stabilization.

Lesson 3. The authorities' decision to treat an arrangement as precautionary poses a risk that, in practice, the standards for IMF support will be weakened. While it is obviously not possible to draw conclusive judgments from a single case, and the IMF's policies make no such distinction between precautionary and other arrangements, the fact that the arrangements during 1997–99 were being treated as precautionary was interpreted by both sides to imply that the IMF's leverage with the Argentine authorities was weak. The precautionary nature of the arrangement and the fact that, as a consequence, the IMF's exposure to Argentina was declining, were taken to justify relatively weak fis-

[8]During good times, there is no incentive for politicians to risk an exit from a successful fixed exchange rate regime, particularly when it enjoys popular support. During bad times, if balance sheet dollarization is extensive or foreign currency exposure is high, the costs of exit are so high that no politician would be willing to take the political risk.

cal and structural conditionality and the regular accommodation of slippages. Weak program design and weak implementation in the context of arrangements being treated as precautionary did not serve the purpose of preventing the country from pursuing policies that proved to be unsustainable. When there is no pressing balance of payments need, it may be better not to agree to an arrangement, thus subjecting the country to market discipline rather than to program reviews by the IMF, especially when there are doubts about a country's ability to implement a strong reform program. At a minimum, the precautionary nature of an arrangement should not be used to justify weaknesses in program design or slippages in implementation.

Lesson 4. While country ownership of IMF-supported programs is critical, it is not sufficient since ownership of misguided or excessively weak policies is likely to lead to an undesirable outcome. Country ownership is important, particularly in areas of economic policy that have far-reaching social implications, but there are often trade-offs between the extent of ownership and the strength of the policies embedded in an IMF-supported program. These trade-offs need to be discussed openly between the IMF and the authorities. An important lesson of the Argentine experience is that strong ownership should not deter the IMF from forcefully making its views known. The IMF should be prepared not to support a strongly owned program, if it is judged inadequate in generating a desired outcome, but should be prepared to explain the rationale and evidence behind such decisions.

Lesson 5. Favorable macroeconomic performance, even if sustained over some period of time, can mask underlying institutional weaknesses that may become insuperable obstacles to any quick restoration of confidence, if growth is disrupted by unfavorable external developments. This is particularly relevant in a country with a history of recurring crises. In Argentina, the IMF broadly identified these weaknesses and sought to address them through structural conditionality and technical assistance. Despite these efforts, many of the fundamental weaknesses in fiscal institutions remained intact and the same weaknesses that had created a repeated cycle of debt default and hyperinflation in earlier decades again proved fatal. The lesson of the Argentine crisis is that institutional weaknesses that are deeply rooted in the political system are very difficult to change, and that the role of an external agent, such as the IMF, in the reform process is unclear. When difficult changes are not forthcoming, even though macroeconomic performance may be favorable, it is probably counterproductive for the IMF to remain engaged in a long-term program relationship.

Crisis management

Lesson 6. Decisions to support a given policy framework necessarily involve a probabilistic judgment, but it is important to make this judgment as rigorously as possible, and to have a fallback strategy in place from the outset in case some critical assumptions do not materialize. In the absence of a well thought-out alternative strategy, and with only an ill-defined exit strategy, it took the IMF a long time to change gears in the face of the demonstrated failure of the program to achieve its stated objectives. This led to repeated attempts to use the same strategy when it was evident that it had failed. The need for contingency planning in a program designed to deal with a capital account crisis has already been noted in the IEO's earlier evaluation report on this topic.[9] The additional lesson of the Argentine experience is that contingency planning efforts should encompass not only alternative strategies but also "stop-loss rules"—that is, a set of criteria to determine if the initial strategy is working and to guide the decision on when a change in approach is needed.

Lesson 7. The catalytic approach to the resolution of a capital account crisis works only under quite stringent conditions. The Argentine experience confirms the lessons drawn from the experience with the other capital account crises of the last decade, as corroborated by two recent IMF studies (Cottarelli and Giannini, 2002; and Mody and Saravia, 2003). These studies suggest that several conditions are required for the catalytic approach to work (Box 4.2). First, economic fundamentals must be sound. Second, the government must be credible in terms of policy actions and past behavior to give confidence to the markets that their concerns have been adequately addressed. Third, serious debt sustainability analysis must suggest that, with high likelihood, the country is not insolvent. Fourth, the exchange rate regime must be broadly assessed to be sustainable. When there are well-founded concerns over debt and exchange rate sustainability, it is unreasonable to expect a voluntary reversal of capital flows.

Lesson 8. Financial engineering in the form of voluntary, market-based debt restructuring is costly and unlikely to improve debt sustainability if it is undertaken under crisis conditions without a credible, comprehensive economic strategy. An important lesson of the Argentine crisis (in particular, the mega-swap of June 2001) is that market-based, NPV-neutral financial engineering operations do not work in the midst of a crisis when risk premia signal

[9]See Recommendation 3 in the evaluation report on the role of the IMF in recent capital account crises, IEO (2003a), p. 53.

Box 4.2. Experience with Catalytic Finance

In all past episodes of a financial crisis triggered by large capital outflows, the catalytic approach had failed before a more flexible exchange rate regime was forced upon the country, except in the case of Argentina in 1995 (when the country's overall economic fundamentals were sounder than in 2000). This was the case even when catalytic or semi-catalytic finance can be considered to have been successful (including Mexico in 1995, Korea in 1998, Brazil in 1999 and 2002, Turkey in 2002–03, and Uruguay in 2002); in these cases, the approach worked only after the fixed exchange rate regime had been abandoned.

In these and other successful cases, moreover, some concerted, as opposed to purely voluntary, elements of PSI were attempted in order to ensure the rollover of international investors' exposure, including in Korea (coordinated rollover and subsequent transformation of interbank lines into medium-term instruments), Brazil (a commitment to maintain interbank exposure supported by strict monitoring), and Uruguay (coordinated restructuring of the public debt). The approach taken in Argentina in 2001 included very little, if any, effective PSI, as all private sector contributions were strictly market-based and not subject to close monitoring, and in the end involved almost exclusively domestic agents.

a high probability of default. This is because such operations are by definition performed at interest rates that are significantly higher than in "normal" times and therefore improve short-run cash flows only at the cost of a higher debt service burden. Even when there is only a liquidity problem, such operations could turn it into a solvency problem.[10] Only a form of debt restructuring that leads to a reduction of the NPV of debt payments or, if the debt is believed to be sustainable, a large financing package by the official sector, has a chance to reverse unfavorable debt dynamics. In either case, financial engineering can only be one piece of an overall policy framework. The fact that these two approaches were successfully used in 2002 in Uruguay and Brazil, respectively, suggests that this lesson has already been learned.

Lesson 9. Delaying the action required to resolve a crisis can significantly raise its eventual cost. When the required policy change has large up-front costs, it is understandable that the authorities of the country concerned will systematically resist the shift and push for additional official financing as long as possible. By the same token, there is a natural reluctance on the part of the IMF to force such a policy shift against the will of the authorities. This reluctance reflects the fear of being blamed for the costs of preemptive action, as well as the difficulty of fitting together the pieces of an alternative policy package. The longer the crisis drags on without its fundamental causes being addressed, however, the larger would be the likely costs to the economy. This is not to say that the costs could be altogether avoided if the action is taken early, but delayed action is likely to lead to further output loss, additional capital flight, and greater deterioration of asset quality in the banking system. To minimize the costs of any crisis, the IMF must be proactive. First, it should make a realistic assessment of the need for a policy shift and, if such a shift is deemed necessary, provide financial support only when the country is able to commit credibly to the policy changes needed to ensure viability, including, if necessary, a commitment to negotiate an NPV-reducing restructuring of the country's obligations. Second, it should stand ready to help the country through the regime shift with a package of policies and financing to minimize the transition costs, as regime changes are typically highly disruptive and risk triggering secondary runs on the banking system and an overshooting of the exchange rate.

Decision-making process

Lesson 10. In order to minimize error and increase effectiveness, risk analysis, accountability, and predictability must be improved in the IMF's decision-making process.

- In the case of Argentina, neither financial risks to the IMF nor the country's capacity to repay were adequately discussed in a formal manner, or early enough to affect decision making. Rules and limits on access to IMF resources are expressed as a percentage of quota. Internal discussions on the level of access thus tend to focus on this metric and the impact of the proposed level of access on the IMF's financial position and risks is hardly examined, even in the case of large borrowers like Argentina. More attention to financial risks in decision making would likely raise the bar on the odds of success required to keep supporting a questionable strategy by a relatively large borrower. In fact, this was one of

[10] As Appendix 8 explains, variants of this voluntary debt reprofiling involving use of official resources as enhancements (either through policy-based guarantees to raise new money as in the case of World Bank operations or through use of IMF resources as in the $3 billion set aside for debt restructuring operations in the September 2001 augmentation) do not change the basic picture that any voluntary debt restructuring under crisis conditions increases the NPV of the debt as measured using the interest rates that prevail during normal times. The use of official resources for such purposes is thus necessarily inefficient.

the first operational lessons discussed by the IMF following the Argentine crisis.

- The Argentine crisis revealed weaknesses in the decision-making process relating to (i) the type of information considered and (ii) lack of transparency regarding who is responsible for a particular decision. The Executive Board, which is formally accountable for financing decisions, is not fully informed of all the factors that staff and management consider when making their recommendation—reflecting in part the highly sensitive nature of some information and concerns about potential leaks. Critical decisions are sometimes made outside the Executive Board in direct interactions between management and the IMF's major shareholders. While informal contacts with major shareholders is a normal and necessary part of management's responsibilities, effective crisis management requires that the locus for decision making remain at the level of the Board—on the basis of candid analysis by the staff. Otherwise, accountability will be weak and suboptimal decisions are more likely.
- There was also a lack of clarity as to why a particular decision was made. The absence of clear rules led to excessive reliance on discretion, which in turn created an environment of great uncertainty and unpredictability as to what the IMF would do next and encouraged the Argentine authorities to pursue questionable measures in an attempt to gamble for redemption.[11] A more rule-based decision-making process could likely result in a faster resolution of a crisis when a solution is uncertain.[12]

Recommendations

Since the Argentine crisis, a number of initiatives have been taken by the IMF to address some of the issues raised above; some changes in procedures and policies were even made before the staff began a systematic effort to draw lessons from this crisis (see PDR, 2003). These changes include: (i) a procedure to systematize and refine debt sustainability exercises as a core tool of analysis; (ii) a procedure to undertake periodic, comprehensive ex post assessments of strategies and policies toward prolonged users of IMF resources; and (iii) a new framework for decisions in exceptional access cases, involving clear criteria to assess need and sustainability,[13] assessment of financial and liquidity risks to the IMF, capacity to repay, use of alternative metrics to determine access, early and more extensive involvement of the Executive Board, and ex post evaluation by staff. While these initiatives, if fully implemented,[14] could go a long way toward ensuring that the mistakes of the Argentine experience will not be repeated, additional steps are necessary to further strengthen these efforts. We present below six sets of recommendations for this purpose, covering crisis management, surveillance, program relationship, and the decision-making process.

Crisis management

Recommendation 1. The 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.

- Crisis response should be part of a coherent strategy that, from the beginning, carefully formulates the goals, the means for measuring the extent to which these goals are being achieved, and alternative plans (including an exit strategy in case the preferred strategy fails and a policy shift is needed). A key element would be to specify how to trigger the exit strategy. The Argentine experience suggests that, for a stop-loss rule to be effective, it must be defined early on and designed in such a way as to be activated before a full-blown crisis becomes unavoidable or key options for dealing with the crisis are no longer available.
- This and other relevant elements of the strategy should be discussed both with the Executive Board and with the authorities (though not necessarily agreed in detail). Particularly when exceptional access is being sought, no decision should be made without alternatives being explicitly spelled out for the Board, along with a balanced discussion of their costs—both in the short run and in the long run—and the respective probabilities of success (see *Recommendation 6* below for a possible modality by which

[11]Some observers have explained that undisciplined economic policymaking in Argentina during 2001, including by Congress, was supported by the general sense that the IMF stood ready to come to Argentina's rescue at all costs.

[12]A rule may not always lead to the best outcome. Any responsible decision would thus require some element of discretion.

[13]The criteria are: (i) exceptional balance of payments pressures in the capital account; (ii) rigorous and systematic debt sustainability analysis indicating that there is a high probability that the debt will remain sustainable; (iii) early expected resumption of access to private capital markets; and (iv) reasonably strong program design and implementation prospects.

[14]A review of exceptional access policy conducted in early 2004 indicated that, as of then, the new framework had not been consistently implemented.

this recommendation can be made operational). The authorities would naturally be reluctant to discuss contingencies openly, fearing that public discussion may undermine the credibility of their commitment to the current strategy. This should not stop the IMF from providing the authorities with its analytical work underlying such contingency planning efforts.

- Particular attention should be paid to financial risks for the IMF under alternative strategies. Strengthened due diligence procedures in analyzing the risks and costs of various alternatives could be considered when either absolute exposure or risk concentration reaches a certain threshold.

Recommendation 2. Where the sustainability of debt or the exchange rate is in question, the IMF should clearly indicate that its support is conditional upon a meaningful shift in the country's policy while remaining actively engaged to foster such a shift. In particular:

- As mandated by the established guidelines, the IMF should firmly refuse to lend in support of a policy framework that has a high probability of being unsustainable or a low probability of being implemented. Equally important, at such times, the IMF should also take the lead in helping the member country in its transition to a new policy regime, including by offering advice on the transition framework and by providing financing to minimize disruptions and output loss.

- In this context, high priority should be given to defining the role of the IMF when a country seeking exceptional access has a solvency rather than a liquidity problem, especially with respect to its public sector debt. As long as there are uncertainties regarding the role that the IMF should play in the process, it will remain impractical to implement the principles of the Prague framework, which have recently been reaffirmed in the new framework on exceptional access. Progress made in incorporating collective action clauses in new issues of sovereign debt and in developing a code of conduct for sovereign debtors and their creditors is a welcome development, but further efforts are needed to clarify the role that the IMF is expected to play. There may be a broad spectrum of options for the role of the IMF to be assigned by the international community, but the solution must be based on the recognition that, in the Argentine experience, the initial lack of a clear mandate for the IMF once it became clear that a pure catalytic role was unlikely to be sufficient led to an unduly protracted delay before a cooperative solution could be found.

Surveillance

Recommendation 3. Medium-term exchange rate and debt sustainability analyses should form the core focus of IMF surveillance. To fulfill these objectives (which are already current policy), the IMF should systematize the following practices:

- When a country maintains a fixed exchange rate, the IMF should refine tools for assessing the equilibrium real exchange rate that are more forward-looking and rely on a variety of criteria, including market indicators, and use such tools for conducting a systematic analysis of the sustainability of the particular exchange rate, given the country's macroeconomic policy and structural constraints.[15] On the basis of these analyses, the IMF should also systematically engage in a substantive policy dialogue with the authorities on the implications of the regime for other policies as well as on appropriate exit strategies. Such a dialogue should be a routine exercise in the context of Article IV consultations. The Executive Board must back such discussions in the face of inevitable political counterpressure.

- Surveillance should examine debt profiles from the perspective of "debt intolerance," recognizing that the same debt stock relative to GDP may pose a serious problem in one case but not in another, depending on the characteristics of the country's economy and the debt. In line with this emphasis on the debt stock, the IMF should in its program design aim to calibrate the fiscal deficit to achieve appropriate reductions in the debt stock rather than merely the reduction or elimination of year-to-year fiscal deficits. Since the fiscal targets emerging from this exercise must reflect the compulsions of countercyclical policy, some of the focus of fiscal conditionality must be on medium-term improvements. An important implication is that adjustments of fiscal targets should be symmetric—a relaxation of targets in years of unexpectedly low growth or recession should be balanced by a willingness to strengthen targets in years when growth exceeds expectations.

- In all aspects of surveillance, including exchange rate and fiscal policies, the IMF should not only examine near-term vulnerabilities but also take a longer-term perspective on vulnerabilities that could surface over the medium term. A horizon of, say, three to five years is in practice better suited for taking remedial action.

[15]Steps in this direction are already being taken.

Program relationship

Recommendation 4. The IMF 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. The markets may well do a better job of disciplining policy than a weak program that is being treated as precautionary. In order to provide an effective signal on whether or not there is adequate political commitment to and domestic ownership of the policy adjustment or structural reform judged to be critical to longer-term sustainability, conditionality in macroeconomic and structural areas that are deemed critical to the achievement of program objectives should be binding, both in design and in implementation. The rationale and analysis underlying any such conditionality should also be made public.

Recommendation 5. Exceptional access should entail a presumption of close cooperation between the authorities and the IMF. While this presumption is supposed to hold in any program, the Argentine case suggests that there can be situations in which an exceptionally high stake for the IMF gives the borrowing country greater leverage. In any event, it is important that no issue be off the table of discussion—including sensitive but macro-critical issues—and that no policy measure or commitment of IMF support beyond the existing terms should be announced by the authorities without prior consultation with the IMF. Incentives to forge such close collaboration in exceptional circumstances could include:

- Mandatory disclosure to the Executive Board of any critical issue that the authorities refuse to discuss with (or any critical information that they refuse to disclose to) staff or management; and
- A presumption that the IMF would not endorse publicly any measure or announcement directly relevant to the IMF-supported program that has not been subject to prior consultation.

The decision-making process

Recommendation 6. The role of the Executive Board needs to be strengthened. The new framework on exceptional access has reaffirmed the role of the Executive Board as the key locus for decision making. For the Board to play this role effectively, there must be procedures to encourage: (i) effective Board oversight of decisions under management's purview; (ii) provision of candid and full information to the Board on all issues relevant to decision making; and (iii) open exchanges of views between management and the Board on all topics, including the most sensitive ones. Such procedures may include:

(a) Members of the Executive Board could be more active in their oversight function, including by exercising their right to call a Board meeting or to request the addition of any topic that concerns them to the Board agenda, when they consider that their concern has not been adequately addressed. Recognizing that decisions on exceptional access involve difficult judgments on a variety of topics, upon which reasonable people may disagree, the Board could formalize the right of Directors to request from management ahead of Board discussion additional staff analysis on issues they consider central to the success of the recommended strategy. This would represent an improvement over the current practice whereby some Directors seek additional information or analyses through informal exchanges with senior staff, which are typically not shared with the entire Board.

(b) Critical issues arise from time to time that are deemed, by management or the Director representing the country concerned, to be too sensitive to be discussed in a full Board meeting. In such cases, the Board effectively yields decision-making power to management or informal subgroups of larger shareholders, weakening its oversight role and accountability. To remedy this problem, the Board and management should work out a procedure to (i) reconcile the need for confidentiality with the need for Board decisions to be based on full and candid information (for example, along the lines of current policy on side-letters) and (ii) ensure that management and staff exercise due diligence to ensure prudent crisis management even when practical considerations require that not all information be disclosed to the Board. Although recent experience with early Board involvement under the new framework for exceptional access suggests that progress has been made in this area, additional steps may be useful. While it is beyond the scope of this evaluation to recommend a specific blueprint, possible arrangements that could be considered include:

- Establish guidelines whereby the Board could explicitly authorize management to withhold certain issues from discussion in a full Board meeting, with a presumption that, once the sensitivity is no longer present, management's decision is ex post subjected to Board scrutiny.

- Extend the heightened confidentiality procedures currently applicable to Board discussion of side-letters to other documents, such as those on exit strategies, stop-loss rules, and other contingency matters.[16]
- Alternatively, assign a small group of Executive Directors, on a rotating basis, to crisis management oversight. These representatives, who should broadly reflect the composition of the Board, would act in their personal capacity and would not have decision-making power, but would act as "trustees" to ascertain that all relevant information is being considered and due diligence procedures are being followed by management and staff.

(c) Enhanced transparency and accountability are key to improving the prospects of full implementation of policies on exceptional access. Thus, staff reports associated with exceptional access cases should be published promptly, and there should be a presumption of ex post independent evaluation of all exceptional access cases.

It goes without saying that these efforts will be successful only insofar as IMF shareholders—especially the largest ones—collectively uphold the role of the Executive Board as the prime locus of decision making in the IMF and affirm their support of transparency and accountability as its guiding principles.

[16]Experience suggests that the policy on side-letters, while not flawless, has at least succeeded in preserving confidentiality.

APPENDIX

The IMF's Financing Arrangements with Argentina, 1991–2002[1]

Stand-By and Extended Arrangements

(In millions of SDRs)

	Board Approval	Expiration or Cancellation	Amount Agreed	Percent of Quota	Amount Drawn	Amount Outstanding
Stand-By Arrangement	7/29/1991	3/30/1992	780	70.1	439	0
Extended Arrangement	3/31/1992	3/30/1996	4,020	361.2	4,020	683
Stand-By Arrangement	4/12/1996	1/11/1998	720	46.8	613	0
Extended Arrangement	2/4/1998	3/10/2000	2,080	135.3	0	0
Stand-By Arrangement	3/10/2000	1/23/2003	16,937	800	9,756	9,015
Of which						
Supplemental Reserve Facility	1/12/2001	1/11/2002	6,087	287.5	5,875	5,134

Yearly Disbursements and Repayments

(In millions of SDRs)

	Disbursements	Repayments	Charges Paid
1991	293	724	174
1992	585	638	127
1993	1,155	275	147
1994	612	290	142
1995	1,559	319	181
1996	548	297	186
1997	321	348	201
1998	0	484	195
1999	0	602	144
2000	1,588	970	148
2001	8,168	928	327
2002	0	574	523

Source: IMF.

[1]As of March 31, 2003.

Appendix 2 Argentina and the IMF Prior to 1991

Argentina entered the decade of the 1990s having experienced a dismal economic performance over a prolonged period of time. From about 1975 through 1990, the country was plagued by high inflation and general economic stagnation. Inflation seldom fell below 100 percent; there were bouts of hyperinflation, notably in 1985 and 1989–90. Real GDP in 1990 stood 6 percent below the level in 1974. Over this period, the general stance of economic policy was inward-looking and interventionist, although there were occasional attempts to adopt more market-oriented policies.

All-out crises erupted twice during the 1980s. Early in the decade, the mounting fiscal imbalances led to high real interest rates, a string of corporate bankruptcies, growing insolvency in the banking system, and a loss of confidence. An overvalued exchange rate had created a large cumulative balance of payments deficit, causing a serious debt service problem and an eventual loss of market access. Inflation accelerated, and real GDP declined by almost 10 percent from 1980 to 1982.

Likewise, in early 1989, a failure to adjust the official exchange rate and public sector prices in the face of accelerating inflation led to a sharp deterioration in the public finances, an attack on the currency, and a substantial loss of foreign exchange reserves. A pickup in inflation in turn created a vicious circle of soaring public sector deficits and further inflation. A suspension of the official exchange market caused external commercial arrears to accumulate. A deep recession ensued, causing real GDP in 1989 to decline by 7 percent from the previous year. During the middle of this crisis, the ruling Radical party lost the national elections, and the administration of President Raúl Alfonsín yielded power to the opposition Justicialist (Peronist) party, five months ahead of schedule.

Over this period, a number of attempts were made to deal with chronic inflation and large balance of payments imbalances. After the mid-1980s, the gradualist approach of early attempts gave way to a more decisive, shock-therapy ("heterodox") approach, beginning with the Austral Plan of June 1985, which introduced a new currency unit, the austral, initially set equivalent to 1,000 pesos. When this failed, additional attempts were made, notably a policy package of October 1987 and the so-called *Plan Primavera* of August 1988.[1] A common feature of these later efforts was the use of wage and price controls, supported by a (temporary) fixing of the exchange rate. But supportive fiscal and monetary policies were not sustained, making the wage-price freeze and the fixed exchange rate untenable. Inflation returned with vengeance.

The new Peronist administration of President Carlos Menem, after taking office in July 1989, immediately designed a package of short-run and medium-term measures to stabilize the economy and to promote growth. The currency was devalued and then fixed at a substantially depreciated level, supported by the strengthening of the public finances. A major program of structural reforms was announced, consisting of an overhaul of the tax collection agencies, privatization of public enterprises, promotion of competition (including from foreign firms), and central bank independence. Two basic laws were passed by Congress: the Law of Reform of the State (authorizing the privatization or liquidation of public enterprises), and the Economic Emergency Law (including measures to improve public finances in the short run and structural reforms over the medium term). In October 1989, the authorities requested an SBA with the IMF, which they indicated would pave the way for a later extended arrangement.

[1] It was within the context of the *Plan Primavera* that a major dispute over Argentina emerged between the IMF and the World Bank in the summer and fall of 1988. Resisting pressure from the U.S. Government, the IMF Managing Director chose not to lend to Argentina because he viewed Argentina's fiscal policy as insufficient to assure lasting stability. The World Bank, on the other hand, went ahead with a package of loans totaling $1.25 billion on the basis of a "Letter of Development Policy," which "included a statement of the authorities' intentions with respect to fiscal policy that was more expansionary than the policy on which the Fund staff was insisting as a condition for the stand-by arrangement." Argentina's subsequent failure to meet the Bank's conditions, and the early collapse of the *Plan Primavera* in February 1989, vindicated the IMF's insistence on fiscal control. See Boughton (2001), pp. 520–24; also OED (1996), p. 18.

There were some early impressive gains. Inflation, which peaked at a monthly rate of almost 200 percent in July 1989, came down to 6 percent a month, while economic activity staged a sharp recovery. There was a marked improvement in fiscal deficits. Capital flows reversed themselves, and the spread between the official and parallel markets all but disappeared. Arrears to multilateral institutions were eliminated. Toward the end of the year, however, there were slippages in policy implementation. Most of the performance criteria under the IMF-supported program for end-December 1989 were missed by wide margins, and there were delays in congressional approval of the revenue measures. The improved economy led to large wage increases. A spread between the official and parallel exchange rates reemerged, and the currency became subject to a speculative attack, followed by a run on the banking system. Consumer prices rose by 90 percent during the final three weeks of December.

The government reacted with decisiveness. On January 1, 1990, in order to eliminate the large quasi-fiscal deficits of the central bank (arising from the sharp increase in interest rates) as a source of money creation, the authorities decreed that all austral-denominated bonds and term deposits in the banking system be converted into 10-year U.S. dollar-denominated government bonds (called BONEX) at LIBOR. In March, and again in September, comprehensive measures were introduced to strengthen the public finances, including an increase in the coverage and rate of VAT. In the meantime, substantial progress was achieved in the latter part of the year in privatization, including the sale of assets held by the state oil company and the finalization of contracts to sell the public telephone company and the national airline. There was some turnaround in capital flows. Inflation came down, though it remained high relative to the United States. The currency, however, continued to depreciate from July to the end of the year, in line with higher inflation and the diminished demand for austral-denominated assets in the aftermath of the compulsory debt conversion.

All in all, between January 1983 and November 1989, the IMF agreed to four SBAs with Argentina, totaling over SDR 5 billion, in support of the country's adjustment programs. Reflecting the difficulty of consistently maintaining the tight fiscal and monetary policies, performance under the IMF-supported programs was unsatisfactory at best. Fiscal targets were frequently violated and, despite some early gains, stabilization was never achieved. The first of these programs was effectively inoperative after four months and was canceled three months before it was to expire. The other three programs were modified, more than once in all three cases, yet the resources made available under the arrangements were never fully drawn, notwithstanding the number of waivers granted for the nonobservance of quantitative performance criteria. Total purchases made by Argentina during the period amounted to about SDR 4.4 billion, including SDR 1.5 billion drawn under the Compensatory Financing Facility.

APPENDIX 3

A Retrospective on Argentina's Fiscal Policy, 1991–2001

By most measures, Argentina's fiscal discipline in the 1990s represented a substantial improvement over the previous decades, largely reflecting increased tax revenue (Table A3.1). Yet, by the end of the decade, Argentina's public sector had come to be perceived as having fiscal problems. There were two reasons to explain this paradox. First, actual fiscal performance was worse than it appeared, because of deficiencies in fiscal accounts. Second, despite the significant improvement, fiscal discipline was insufficient relative to the strict constraints imposed by the convertibility regime, particularly when the country was hit by a series of adverse external shocks. In this appendix, we present four aspects of this explanation, by employing several alternative (and not necessarily consistent) data sources, including those provided by Argentine scholars.

Initial gains in fiscal discipline were not sustained. Most of the improvement in fiscal accounts took place during 1991–94, but the later years saw a deterioration (Table A3.2). In particular, the persistent deterioration in the overall balance of the consolidated public sector reflected a gradual increase in interest payments and other expenditures, while revenue did not keep pace. It was, however, only in 2001 that, with the economy in its third year of recession and soaring interest premia on Argentine debt, the overall balance reached pre-1990s levels.

Issuance of debt to finance off-budget expenditures led to a steady increase in debt that was substantially greater than the cumulative deficits. This explains why the stock of public debt doubled as a share of GDP between 1992 and 2001, when fiscal deficits appeared moderate and the government was receiving significant revenue from privatization (Table A3.3). Some of the off-budget expenditures represented the recognition of preexisting debt (such as overdue obligations to pensioners and suppliers), but it is said that bonds were also issued to pay for ordinary expenditures.[1] In any case, the treatment of these expenditures in the budget represented the lack of fiscal transparency.

The 1994 reform of the social security system (along with associated core decisions and tax changes) led to an increase in public debt and a deterioration of fiscal balance (Table A3.4). Two factors contributed to this. First, court decisions upheld the obligation of the government to honor the overdue pension payments of almost $7 billion upon which it had remained delinquent since 1991 (see Schulthess and Demarco, 1993). Second, the reform only slightly reduced the benefits, while cutting the collection of social security tax by almost 40 percent (both through lower tax rates and through a transfer of contributions to the new system). This is not to say that the pension reform itself was ill-conceived. The system was clearly underfunded,[2] and it was appropriate to address the problem when the economy was booming and fiscal accounts were substantially in better shape; moreover, a part of the loss of social security contributions had a counterpart in the reduced future benefits to those leaving the system.[3] Nevertheless, the way in which the reform was done magnified the country's fiscal problems.

Fiscal federalism, as practiced in Argentina, made overall fiscal accounts less reliable and fiscal control more difficult. The provincial finances constitute a significant part of the consolidated fiscal account of the public sector in Argentina (Table A3.5). In fact, the assignment of tax resources and spending responsibilities between the federal and provincial govern-

[1]According to Teijeiro (1996, 2001), $31 billion in fiscal expenditure was "paid for with bonds" during the decade. Though his estimates could be challenged on some grounds (including the use of nominal value in the absence of market value), the overall numbers are not very different from the recent estimates provided by IMF staff.

[2]As an indication of the magnitude of the underfunding, the ratio of workers to retirees was only 1.3, and while workers paid about 26 percent of salary to the federal social security system, pension benefits were set at 70 percent of wages. See Cetrángolo and Jiménez (2003).

[3]In fact, if contributions and benefits were set to match in present value, there would be no cost of transition to a funded system: a fund accumulated from earlier contributions could be used to pay for the benefits. In Argentina, like in most PAYG systems, such a fund did not exist (because any social security surplus was used to finance general expenditure and the benefits exceeded the amount funded by lifetime contributions).

Table A3.1. Public Sector Balance, 1961–2000

(Annual average; in percent of GDP)

	Public Sector Balance		Gross Revenues		
Period	Overall	Primary	Total	Taxes on goods and services	Social security
1991–2000	1.27	0.58	17.38	8.75	4.32
1981–90	6.23	4.38	12.57	6.17	2.87
1971–80	6.66	5.73	13.97	5.47	4.51
1961–70	3.46	2.9	13.86	4.85	4.20

Source: Cetrángolo and Jiménez (2003), Tables 1 and 4.

Table A3.2. Consolidated Public Sector

(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Balance	–0.4	0.0	–1.4	–2.3	–3.1	–2.0	–2.0	–4.1	–3.6	–6.3
Revenues	23.4	24.6	24.2	23.2	22.2	23.2	23.8	24.3	24.7	23.6
Expenditures	23.8	24.6	25.6	25.5	25.4	25.3	25.9	28.5	28.4	29.9
Primary balance	1.4	1.4	0.2	–0.5	–1.1	0.3	0.6	–0.7	0.4	–1.4

Source: PDR (2003).

Table A3.3. Adjusted Fiscal Balance

(Adjusted for off-budget expenditures; in percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
IMF estimate	–3.1	–3.4	–3.9	–3.4	–4.0	–2.6	–2.5	–4.8	–4.2	–6.9
Teijeiro (2001)	–4.8	–4.8	–3.5	–4.9	–5.5	–2.1	–3.7	–6.6	–5.4	n.a.
Balance implied by the increase in public debt[1]		–1.2	–4.4	–1.4	–3.9	–0.9	–4.4	–4.3	–2.8	–8.8
Memorandum items:										
Privatization revenue		0.4	0.4	0.6	0.4	0.6	0.2	1.0	0.1	0.1
Public debt (end of period)	30.7	30.6	33.7	36.7	39.1	37.7	40.9	47.6	50.9	62.2

Sources: IMF database; Teijeiro (2001); and IEO estimates.
[1]Change in debt plus privatization receipts.

Table A3.4. Social Security Balance

(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Social security contributions[1]	5.4	5.6	5.4	4.8	4.0	3.8	3.7	3.6	3.4	3.3
Pension payments[1]	6.1	5.6	6.2	6.1	5.7	5.9	5.9	6.2	6.1	6.2
Balance[1]	–0.7	. . .	–0.8	–1.3	–1.7	–2.1	–2.2	–2.6	–2.7	–2.9
Memorandum items:										
Net effect of 1994 reform[2]			–0.8	–1.4	–2.2	–2.4	–2.4	–2.7	–2.9	–2.7
Social security contributions[1]	5.4	5.6	5.4	4.8	4.0	3.8	3.7	3.6	3.4	3.3

[1]Cetrángolo and Jiménez (2003), Tables A.3 and A.9.
[2]Revenue loss due to pension reform, plus assumption cost of provincial pension systems, minus savings in expenditures. Rofman (2002), Table 1.

Table A3.5. Federal and Provincial Fiscal Accounts
(In percent of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Federal government										
Total expenditures	18.93	18.04	18.76	19.62	19.11	20.09	20.26	21.93	21.96	22.02
Of which										
Transfers to provinces	6.06	5.72	5.74	5.62	5.84	6.04	6.13	6.29	6.35	5.93
Total revenues	19.55	19.19	18.73	19.09	17.18	18.63	18.9	20.25	19.57	18.78
Fiscal balance	0.62	1.15	–0.03	–0.53	–1.93	–1.46	–1.36	–1.68	–2.39	–3.24
Consolidated provincial governments										
Total expenditures	10.75	11.53	11.48	11.61	11.13	11.18	11.73	12.83	12.61	13.47
Of which										
Personnel	5.75	5.99	5.86	5.87	5.42	5.34	5.63	6.37	6.52	6.98
Total revenues										
Provincial taxes	3.54	3.72	3.76	3.55	3.6	3.72	3.9	3.9	3.82	3.63
Coparticipation federal taxes	6.92	7.07	6.87	6.8	7.09	7.42	7.18	7.48	7.63	7.52
Fiscal balance	–0.29	–0.74	–0.85	–1.26	–0.44	–0.04	–0.65	–1.45	–1.16	–2.32

Source: Cetrángolo and Jiménez (2003), Tables A.2 and A.5.

ments has remained one of the most contentious fiscal issues. As a notable feature of Argentina's fiscal federalism, the bulk of provincial revenue comes from "*coparticipation*" of federal taxes, according to revenue-sharing criteria that have changed over time through various fiscal pacts (Schwartz and Liuksila, 1997; and Cuevas, 2003). At the same time, starting in 1993, a program of decentralization transferred to the provinces more and more of the responsibility for basic social services, but without a significant reduction in federal expenditures. This system has created adverse incentives,[4] and increased complexity and opacity in the true fiscal picture.

[4]The system allows elected officials to enjoy the political benefits of spending without much of the costs of tax collection; creates procyclical patterns in provincial spending; and limits fiscal planning by subjecting revenue sharing to political negotiations.

Appendix 4

Selected Program Conditionality, 1991–2001[1]

Date of Approval	Arrangement	Quantitative Performance Criteria	Structural Performance Criteria	Structural Benchmarks
7/29/91	Stand-By Arrangement	1. Overall NFPS cash balance 2. Combined NFPS/CB balance 3. Treasury outlays 4. Cumulative NDA change 5. Cumulative NIR change 6. External PS arrears 7. Total outstanding disbursed external PS debt 8. Cumulative net disbursements of short-term PS debt		
3/31/92	Extended Arrangement	1. Overall NFPS cash balance 2. Combined NFPS/CB balance 3. Cumulative NDA change 4. Cumulative NIR change 5. External PS arrears 6. Total outstanding disbursed external PS debt 7. Cumulative net disbursements of short-term PS debt	1. Implement by June 30, 1992, tax reform aimed at replacing income tax by taxes on distributed profits and business primary surplus. 2. Implement by December 31, 1992, social security reform to achieve financial balance on cost and accrual basis.	
4/12/96	Stand-By Arrangement	1. Cumulative PS balance 2. Cumulative ceiling on federal noninterest expenditure 3. Cumulative NDA change 4. Cumulative change in free international reserves 5. Cumulative net disbursements of PS debt 6. Cumulative net increase in short-term PS debt		
2/4/98	Extended Arrangement	1. Cumulative federal deficit 2. Cumulative NDA change 3. Cumulative net disbursements of PS debt 4. Cumulative net increase in short-term PS debt Indicative targets: 1. Cumulative ceiling on federal noninterest expenditure[2] 2. Combined federal and provincial deficits		• By the first review, implement single presumptive tax, tax administration program, and labor market reform; present to Congress tax reform bill; and lease airports and telecom frequencies. • By the second review, obtain congressional approval of tax reform and new anti-trust law; implement reforms of tax administration, budgetary operations, social security system, and financial system; and submit to Congress draft legislation on privatization of Banco Nación.

Date of Approval	Arrangement	Quantitative Performance Criteria	Structural Performance Criteria	Structural Benchmarks
3/10/00	Stand-By Arrangement	1. Cumulative federal balance 2. Cumulative federal primary expenditure 3. Cumulative change in federal debt 4. Cumulative change in short-term federal debt 5. Cumulative NDA change 6. Cumulative change in consolidated PS debt[3] Indicative target: 1. Cumulative consolidated provincial balance		• By the first review, implement reforms of labor market, tax administration, and arrangements to monitor provincial finances; and submit to Congress reform plans for social security, revenue sharing, and Banco Nación. • By the second review, implement social security reform; modify central bank charter and banking law; and complete conversion of Banco Nación into public corporation.
1/12/01	Second review under Stand-By Arrangement	1. Cumulative federal balance 2. Cumulative federal primary expenditure 3. Cumulative change in federal debt 4. Cumulative change in short-term federal debt 5. Stock of NDA 6. Cumulative change in consolidated PS debt Indicative target: 1. Cumulative consolidated provincial balance		• By the third review, issue presidential decree strengthening and consolidating tax payments facilities; design national tax audit plan; begin to set up Tax Frauds Tribunal; issue regulations for proposed pension reform and Protection of Competition Law; and prepare plans to restructure social security family allowances. • By the fourth review, implement plans to restructure family allowances; issue regulatory proposal for ports system; and announce timetable for elimination of CET surcharge.
5/21/01	Third review under Stand-By Arrangement	1. Cumulative federal balance 2. Cumulative federal primary expenditure 3. Cumulative change in federal debt 4. Cumulative change in short-term federal debt 5. Stock of NDA 6. Cumulative change in consolidated PS debt Indicative target: 1. Cumulative consolidated provincial balance		• By the fourth review, implement plans to streamline tax payments facilities arrangements and to restructure family allowances; submit to Congress draft law on pension reform; issue regulatory proposal for ports system; and announce timetable for elimination of CET surcharge. • By the fifth review, complete 80,000 desk audits; present legislation to facilitate banking resolution; and implement new regulatory framework for telecom sector.
9/7/01	Fourth review under Stand-By Arrangement	1. Cumulative federal balance 2. Cumulative change in federal debt 3. Cumulative change in short-term federal debt 4. Stock of NDA 5. Cumulative change in consolidated PS debt Indicative targets: 1. Cumulative consolidated provincial balance 2. Cumulative federal primary expenditure		• By the fifth review, complete 80,000 desk audits; implement plans to streamline tax payments facilities arrangements, strengthen tax collections, and restructure family allowances; submit to Congress reform legislation on revenue sharing; and strengthen compliance with prudential and reporting requirements for public banks. • By the sixth review, complete 100,000 desk audits; and fully implement Tax Frauds Tribunal.

Sources: Various IMF staff reports.
[1]Abbreviations are as follows: NFPS (nonfinancial public sector); CB (central bank); CET (common external tariff); NDA (net domestic assets); NIR (net international reserves); and PS (public sector).
[2]Later converted into a performance criterion.
[3]Binding from the fourth quarter of 2000.

Appendix 5

Economic Characteristics of Major Emerging Market Economies

Relative to other major emerging market economies of Latin America and Asia during the 1990s, the following economic features of Argentina stand out (Table A5.1).[1]

General Economic Structure

Argentina had a particularly low gross savings rate, a particularly small market for domestic debt (comprising bank loans and debt securities) and, along with Brazil, a particularly small export sector. The small size of the domestic debt market was in part a reflection of the low savings rate, and caused Argentina's public sector to borrow heavily in international capital markets.

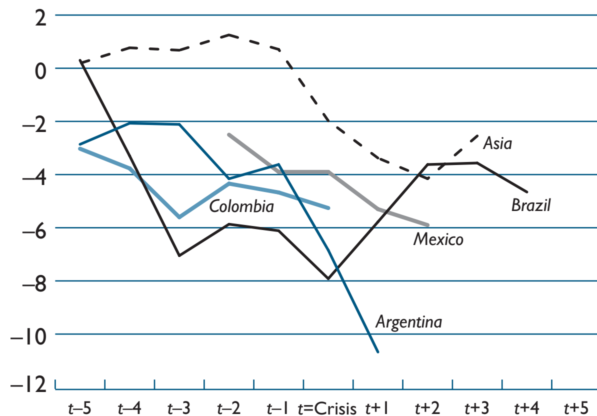
External Debt Structure

Relative to GDP, Argentina's external debt was not so high. Its ratio to exports (at 370 percent), however, was substantially higher than in other countries, though comparable to Brazil's. An important feature of Argentina's public debt structure was that a substantial portion (about 90 percent for 1996–99) was foreign currency denominated, compared to the average of 56 percent for the comparator countries.

Fiscal Structure

The average fiscal balance of Argentina's general government was a deficit of 2.5 percent of GDP during 1990–2001, which was worse than the balances in all other countries except in Brazil, but the overall fiscal characteristics cannot be said to be too different from its comparator countries. Argentina's fiscal balances, however, deteriorated sharply from the late 1990s. At the onset of the crisis in 2001, its general fiscal deficit was as large as Brazil's (in 1998) and far larger than those of the other crisis-hit countries at the time of the crisis (Figure A5.1).

Figure A5.1. General Government Fiscal Balance in Crisis Countries
(In percent of GDP)



Sources: IMF, *Government Finance Statistics Yearbook*; and Collyns and Kincaid (2003).

Note: Asia is Indonesia, Korea, Malaysia, Thailand, and the Philippines. Crisis time is 2002 for Colombia; 2001 for Argentina; 1998 for Brazil, Indonesia, Malaysia, and the Philippines; 1997 for Thailand and Korea; and 1995 for Mexico. Chile did not have a clear crisis. Data for Korea are the central government balance. Data for Mexico are the public sector balance.

[1]Here we consider Brazil, Chile, Colombia, Mexico (from Latin America), Indonesia, Korea, Malaysia, the Philippines, and Thailand (from Asia).

Table A5.1. Indicators of Economic Structure in Selected Emerging Market Economies
(In percent; period average)

	Period	Argentina	Brazil	Chile	Colombia	Indonesia	Korea	Malaysia	Mexico	Philippines	Thailand	Average
Gross savings/GDP	1990–2001	14.8	18.6	21.9	17.5	26.3	34.1	34.5	19.6	20.5	33.0	24.1
Exports/GDP	1990–2001	9.4	9.3	30.7	17.6	32.4	34.4	96.1	24.9	40.5	46.9	34.2
Domestic debt market/GDP	1992–2001	42.0	123.1	110.4	. . .	. . .	125.4	218.2	46.9	91.6	147.9	113.2
External debt/GDP	1990–2001	41.3	52.7	45.6	40.4	79.5	28.4	44.8	41.6	70.6	61.0	50.6
External debt/exports	1990–2001	368.2	322.4	143.3	190.6	226.4	62.1	43.7	146.5	145.2	116.0	176.4
Short-term external debt/ foreign reserves	1992–2001	110.3	79.9	37.4	46.5	64.5	167.0	28.9	75.6	99.4	96.0	80.6
Foreign-currency-denominated debt/ total public sector debt[1]	1996–1999	89.2	. . .	26.5	51.8	98.8	. . .	14.2	65.9	42.4	61.6	56.3
General government												
Overall balance/GDP	1990–2001	–2.5	–3.5	0.2	–2.2	–0.9	. . .	–0.6	–2.7	–2.4	0.7	–1.6
Total revenue and grants/GDP	1990–2001	22.0	28.9	21.7	23.5	17.3	. . .	29.0	22.7	17.7	17.4	22.2
Central government												
Total expenditure and net lending/GDP	1990–2001	19.6	20.2	20.4	16.1	18.2	21.4	24.3	16.6	20.1	. . .	19.6

Sources: IMF database; Bank for International Settlements; World Bank; Organization for Economic Cooperation and Development; Argentina, Ministry of Economy and Production; and Brazil, Ministry of Finance.

[1]Public sector debt for Argentina and central government debt for the rest of the countries. Argentina's debt includes the debt of the central bank and the government-guaranteed debt of public sector banks. Argentina's foreign-currency-denominated debt is the sum of bilateral and multilateral loans, and foreign-currency-denominated bonds and securities. It does not include foreign-currency-denominated loans from private banks.

Appendix 6 Debt Sustainability Analysis

The IMF's Policy Development and Review Department (PDR) has recently proposed a methodology to assess the fiscal and external sustainability of a country, which has become a standard template for such analyses within the IMF.[1] A relevant question to ask for evaluation purposes is whether the proposed analytical framework, if available in late 2000, would have indicated a warning signal that Argentina's public and external debts were potentially unsustainable. In this appendix, we apply the World Economic Outlook (WEO) projections—presumably reflecting the best (albeit rather optimistic) information available to IMF staff—to the standard templates for fiscal and external sustainability analyses for the period 1998–2001, in order to see if the results of such exercises would have suggested a different course of action than the one actually chosen.

At the outset, two qualifications must be stressed. First, data requirements are quite stringent for both fiscal and external sustainability analyses, but particularly for sensitivity analysis in the fiscal sustainability template. Even with the benefit of several intervening years, it is still not possible to obtain accurate actual data for all the variables called for by the template. This means that considerable discretion and subjective judgments are involved in using the framework and interpreting its results. Second, the proposed methodology calibrates debt-stabilizing primary balances (for public debt sustainability) and debt-stabilizing noninterest current account balances (for external debt sustainability), based on a given set of projections.[2] There is, however, no consensus on what the sustainable level of debt would be for a given country, hence what primary or noninterest current account surplus would be needed to prevent the debt from reaching that level. The notion of sustainability thus remains inherently subjective.

In what follows, we will present the results of sustainability analyses, with the appropriate modifications and adjustments of WEO projections as inputs (the basic scenario).[3] Several sensitivity analyses were also performed, using a combination of projections positing an adverse shock of two standard deviations from historical average for each key variable at $t + 1$ and $t + 2$ and a real one-time depreciation of 30 percent at $t + 1$.[4] These results are not reported here because the basic scenario has yielded sufficiently illustrative results for our purpose, but the results of the basic scenario are compared to those obtainable from using consensus forecasts.

The accompanying figures will show, for each scenario, a profile of debt-stabilizing balances that were consistent with the projections made at WEO forecast points (i.e., May and October of each year); these balances are constant "steady-state" surpluses that would stabilize the relevant debt to GDP ratio at its $t + 5$ projected value, assuming that the key variables also remain at their $t + 5$ projected values. A steady-state surplus can be interpreted as the adjustment effort required to stabilize the debt, relative to the country's historical performance.

External Sustainability Analysis

Figure A6.1 summarizes the results of external sustainability analysis. Panel A indicates the eight profiles of the external debt-to-GDP ratio that are implied by the eight respective sets of WEO projections for the key variables. It is worth noting that an earlier WEO forecast (e.g., May 1998, October 1998, and May 1999) yielded a gradual rise in the debt ratio from a relatively low level, while the later forecasts yielded a gradual decline from a relatively high level. PDR suggests a benchmark of 40 percent, at which point the conditional probability of crisis

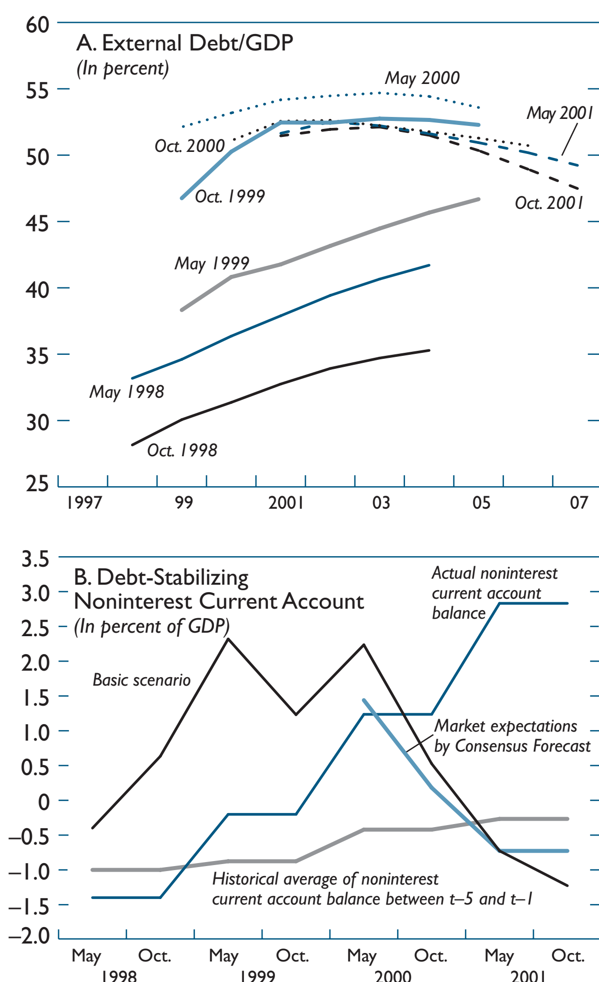
[1]See "Assessing Sustainability," SM/02/166, May 2002; and "Sustainability Assessments—Review of Applications and Methodological Refinements," SM/03/206, June 2003.

[2]The template also calibrates public sector and external sector gross financing needs consistent with the projections.

[3]For the modifications and adjustments made, see the annex to this appendix.

[4]The key variables are: (for fiscal sustainability analysis) real GDP growth, real interest rate, and primary balance in percent of GDP; and (for external debt analysis) real GDP growth, nominal interest rate, dollar deflator growth, noninterest current account in percent of GDP, and nondebt inflows in percent of GDP.

Figure A6.1. External Debt Sustainability



Sources: IMF database; and Consensus Economics, Inc.

becomes about 15–20 percent.[5] According to Panel A, Argentina's projected debt-to-GDP ratio consistently exceeded the critical 40 percent for most of the period. If we consider the actual level of 50 percent at the time of the crisis in 2000–01 as the benchmark, the template would have sounded alarm from October 1999 onward.

Panel B depicts a profile of the debt-stabilizing noninterest current account balances consistent with the WEO forecasts at each forecast point. For example, the balance of about 0.5 percent of GDP in October 2000 meant that a surplus of that magnitude was required to stabilize the external debt to GDP ratio at 50.7 percent of GDP (from $t+5$ onward). In contrast, the historical average balance was a deficit of more than 0.5 percent of GDP. This means that a turnaround of more than 1 percent of GDP was required (relative to past performance) in the noninterest current account balance. The required surpluses derived from the WEO projections were quite similar to those derived from the consensus forecast.

While the required surpluses suggested in 2000 may not seem so large, at least two qualifications must be kept in mind in interpreting this result. First, by the fall of 2000, the WEO projections had already incorporated the assumption of declining external debt-to-GDP ratios. If the May 2000 WEO projections had been used, the template would have indicated a required turnaround of more 2.5 percent of GDP. Second, the stabilizing debt level of 50 percent of GDP was high for any country, but particularly for Argentina, given the likely overvaluation of the peso. With the sharp depreciation of the peso against the U.S. dollar, in the event, Argentina's external debt-to-GDP ratio rose to over 140 percent in 2002.

[5]See "Sustainability Assessments—Review of Applications and Methodological Refinements," SM/03/206, June 2003.

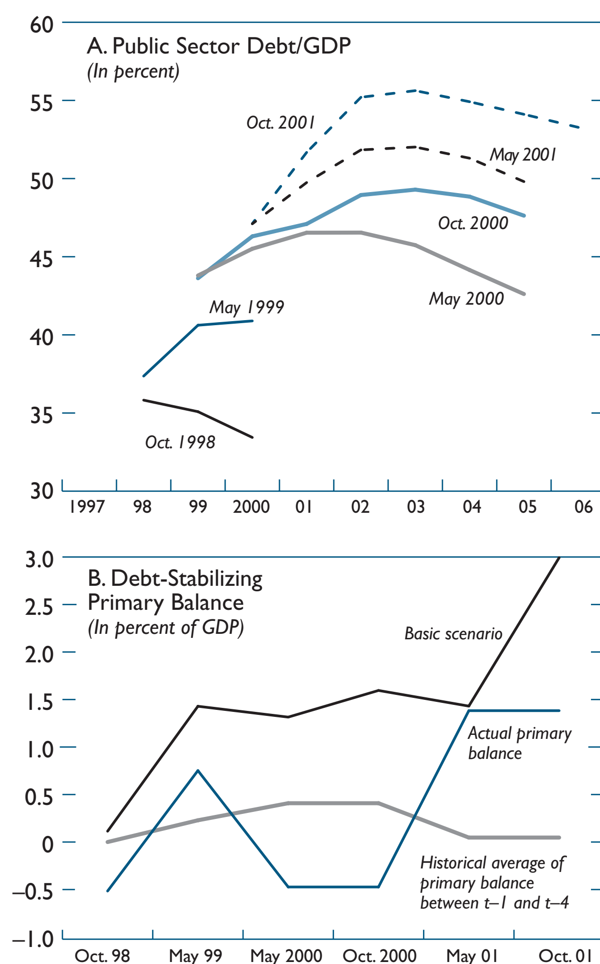
Fiscal Sustainability Analysis

Figure A6.2 summarizes the results of fiscal sustainability analysis. Panel A indicates the six profiles of the public debt to GDP ratio that are implied by the six respective sets of WEO projections for the key variables. It is worth noting that the earliest WEO forecast (October 1998) yielded a projection showing a steady decline in the ratio, while the next forecast (May 1999) yielded a gradual rise in the projected ratio from a relatively low level. In each projection, the debt-to-GDP ratio stabilized over the forecast horizon (meaning that the WEO projections incorporated the assumption of debt sustainability, that is, sufficiently strong fiscal action from $t + 1$ to $t + 4$), but the profile kept shifting up for each projection.

Panel B depicts a profile of the debt-stabilizing primary balances consistent with the WEO forecasts at each forecast point. For example, the primary balance of 1.6 percent of GDP in October 2000 meant that a primary surplus of that magnitude was required to stabilize the public debt-to-GDP ratio at 47.6 percent of GDP (from $t + 5$ onward), while the primary balance was barely in balance over the past five years, and the actual balance for that year turned out to be a deficit of about 0.5 percent of GDP.

Fiscal sustainability analysis is difficult to interpret because the critical benchmark for sustainability is not known. It turns out that what exploded the debt-to-GDP ratio in Argentina was a sharp depreciation of the peso associated with an exit from the peg. As long as the sustainable level of debt was overestimated, and the extent of any exchange rate

Figure A6.2. Public Debt Sustainability



Source: IMF database.

overvaluation (or any overshooting in the event of an exit) was underestimated, debt sustainability analysis would have been of limited use in late 2000.

Annex on Data Modifications and Adjustments

Several modifications and adjustments were made to the data. First, our own estimates were used when no forecasts were available. For foreign-currency-denominated public sector debt, amortization of medium- and long-term public sector debt, short-term public sector debt, and interest payments on foreign-currency-denominated debt, we used their latest available shares relative to total debt and applied the ratios to the projected total debt. For privatization receipts, recognition of implicit or contingent liabilities, cost of bank recapitalization, and local-currency-denominated external debt (excluding exchange-rate-linked debt), we assumed zero for the entire period.

Second, fiscal sustainability analysis requires gross public sector debt projections, but WEO only provides net public sector debt projections. Consequently, we used gross debt projections as provided in the program reviews, ignoring the occasional mismatch in timing between the WEO projections and the program reviews. When the program reviews do not provide five-year projections, the last available projections were used.

Third, a market consensus is taken from the April and October issues of the *Latin American Consensus Forecast*. The consensus forecasts, however, only provide projections for real GDP growth, exchange rate appreciation, consumer price index (used in place of GDP deflator), and the current account balance. For the nominal external interest rate, real and nominal interest rates on public debt, and net non-debt creating capital inflows, the WEO projections were used. As the consensus forecasts for exchange rate appreciation are only available for two years, the projections for subsequent years were assumed to have zero percentage change.

Finally, our exercise yields results that are different from those of a similar exercise performed by PDR comparing early 1999 program projections with actual outcomes.[6] The main difference is that the PDR exercise uses GDP data for historical years that already incorporate subsequent data revisions. Our exercise, as noted, consistently uses the WEO projections where available, supplemented by other projections that can be reasonably thought to have been available at each forecast point—consistent with our focus on the information available to staff and the authorities at the time.

[6]As reported in "Assessing Sustainability," SM/02/166, May 2002; and "Sustainability Assessments—Review of Applications and Methodological Refinements," SM/03/206, June 2003.

APPENDIX 7 A Preliminary Analysis of the 2001 Mega-Swap

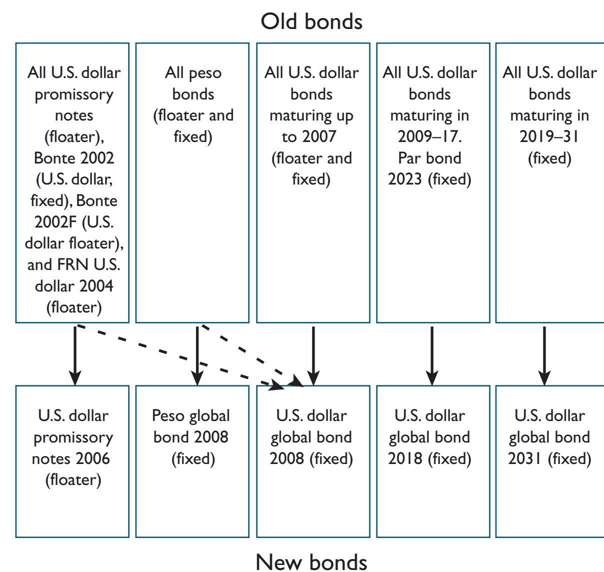
In this appendix, we present a preliminary analysis of the mega-swap of June 2001. The analysis is preliminary in the sense that it only uses publicly available information on individual bond issues, as obtained from Bloomberg, and may not fully take account of possible intricacies and peculiarities of some specific bond issues. The analysis, however, uses latest data, as made available from the Argentine Ministry of Economy and Production, and utilizes more frequent compounding and more detailed assumptions about future floating coupons than those employed by the IMF's internal assessment of the swap in 2001.[1]

The 2001 mega-swap was exercised on a market basis through an auction. The Argentine government started the auction on May 24 and concluded it on June 1. The auction result was announced on June 3, and the bonds were swapped on June 19. The swap was aimed at reducing payment obligations, particularly during 2001–05, by interest capitalizations and duration extensions. The government offered five new bonds in exchange for 52 eligible bonds. Both the new bonds and old bonds had varied structures. The swap was designed strictly in accordance with the government's guidelines, as outlined in Figure A7.1. For example, long-term bonds were swapped with long-term bonds. Fixed-coupon bonds were in principle swapped with fixed bonds. U.S. dollar-denominated bonds were only allowed to be swapped with U.S. dollar-denominated bonds. By this structure, the swap increased the amount of fixed-coupon bonds, dollar-denominated bonds, and long-term bonds.

The swap achieved the government's objectives. As Table A7.1 indicates, the (weighted) maturity of bonds was extended by 3.73 years and the (weighted) coupon raised by 1.11 percentage points,[2] while the (unweighted) discount rate over face value increased by 2.3 percentage points (for details, see Table A7.2). The payment obligation in 2001–05 was significantly reduced; particularly for 2001–02, the new bonds had no principal payment obligations. The payment obligations after 2006, however, increased substantially. In total, the stock of debt increased by $907 million in face value. Because the swap was market-based, the market values of the old bonds and the new bonds were the same ($23.2 billion), meaning that the government bought back $29.5 billion of old bonds and sold $30.4 billion of new bonds, both at $23.2 billion.

In order to see the full impact of the swap, one would need to think in terms of net present value (NPV). One's assessment of the actual costs and benefits from the swap would depend on one's assessment of what constitutes a normal interest rate for Argentina. As stated in the text, an important lesson of the Argentine crisis is that market-based and voluntary financial engineering operations, such as

Figure A7.1. Exchange Options



Sources: IMF documents; and Argentina, Ministry of Economy and Production.

[1]"Argentina—An Assessment of the Debt Exchange Operation," SM/01/204, July 2001.

[2]These are weighted by face value.

Table A7.1. An Overview of the Mega-Swap

Basic Comparison

	New	Old	Difference
Face value (in millions of U.S. dollars)	30,401	29,494	907
Of which			
Fixed	28,371	20,312	8,059
(Percent of total)	93	69	24
Years to maturity (in years from 6/19/01)	16	12	4
Of which			
Fixed	17	16	1
Coupon (fixed bonds, percent)[1]	12	11	1
Premium/discount (in percent)	–24	–21	–3

[1]Weighted by face value.

Present Values in June 2001

(In millions of U.S. dollars, unless otherwise indicated)

	Interest Payments		Principal Payments		Interest + Principal		
Discount Rate Used	New	Old	New	Old	New	Old	New – Old
14.22 percent (6/1/01)	15,797	13,588	8,667	11,825	24,464	25,413	–949
Of which							
Fixed	15,059	12,190	7,278	4,858	22,337	17,048	5,289
(Percent of total)	95.3	89.7	84.0	41.1	91.3	67.1	
10.75 percent (12/31/99)	20,921	16,037	11,434	13,443	32,355	29,480	2,875
Of which							
Fixed	20,130	14,527	9,878	6,107	30,008	20,634	9,374
(Percent of total)	96.2	90.6	86.4	45.4	92.7	70.0	
11.92 percent (12/29/00)	18,945	15,114	10,360	12,826	29,305	27,940	1,365
Of which							
Fixed	18,172	13,645	8,864	5,621	27,036	19,266	7,770
(Percent of total)	95.9	90.3	85.6	43.8	92.3	69.0	
19.64 percent (9/28/01)	10,940	11,043	6,052	10,181	16,992	21,224	–4,232
Of which							
Fixed	10,272	9,772	4,878	3,695	15,150	13,467	1,683
(Percent of total)	93.9	88.5	80.6	36.3	89.2	63.5	

Accumulated Payment

(In millions of U.S. dollars, unless otherwise indicated)

	Interest Payments		Principal Payments		Interest + Principal		
	New	Old	New	Old	New	Old	New – Old
Jun/01–Dec/02	1,604	4,210	0	5,551	1,604	9,761	–8,157
Of which							
Fixed	1,343	3,303	0	525	1,343	3,828	–2,485
(Percent of total)	84	78	. . .	9	84	39	
Jan/03–Dec/05	3,395	6,352	1,894	6,156	5,289	12,508	–7,219
Of which							
Fixed	2,685	5,773	0	2,952	2,685	8,725	–6,040
(Percent of total)	79	91	. . .	48	51	70	
Jan/06–Dec/10	17,362	7,855	12,766	3,106	30,128	10,961	19,167
Of which							
Fixed	17,331	7,621	12,387	2,705	29,718	10,326	19,392
(Percent of total)	100	97	97	87	99	94	
Jan/11–	48,306	16,911	28,783	14,681	77,089	31,592	45,497
Of which							
Fixed	48,306	16,411	28,783	14,130	77,089	30,541	46,548
(Percent of total)	100	97	100	96	100	97	

Note: For U.S. dollar LIBOR-linked floaters, the coupon rate is set equal to the U.S. dollar LIBOR forward rate. For Argentine domestic interest-rate-linked floaters except for FRAN 2004 and FRAN 2005, the coupon rate is set equal to the U.S. dollar LIBOR plus the spread between the U.S. dollar LIBOR and the benchmark interest rate on 6/19/01. For FRAN 2004 and FRAN 2005, the coupon rate is the last coupon rate before 6/19/01. EMBI Global Argentina stripped yields are used as discount rates. Interest capitalization is included in the principal payment. These estimates do not consider the call schedule (even when bonds are callable), the released collateral, or the accrued interest (in the case of Brady bonds).

Table A7.2. Details of Old and New Bonds

Status	Name	Security Type	Currency	Coupon	Coupon Frequency	Issue Amount (In millions of U.S. dollars)	Issue Date	Final Maturity Date	Years to Maturity at Issue Date	Years to Maturity at 6/19/2001	Sinkable	Floater	Exchange Face Value (In millions of U.S. dollars)	Exchange Amount at Market Price	Premium (+) Discount (–) (In percent)	Received Offer (In millions)
New	BP 2006	Pagares	USD	E+580	12	. . .	6/19/2001	6/19/2006	5.0	5.0	Y	Y	2,030	2,030	0.0	. . .
New	Nuevo GL 08	Global	USD	7/15.5	2	. . .	6/19/2001	12/19/2008	7.5	7.5	Y	N	11,456	8,999	–21.7	. . .
New	Nuevo GL 18	Global	USD	12.25	2	. . .	6/19/2001	6/19/2018	17.0	17.0	Y	N	7,463	5,467	–21.4	. . .
New	Nuevo GL 31	Global	USD	12.00	2	. . .	6/19/2001	6/19/2031	30.0	30.0	N	N	8,521	6,024	–26.8	. . .
New	Nuevo GL Peso 08	Global	ARS	10/12	2	. . .	6/19/2001	9/19/2008	7.3	7.3	N	N	931	729	–29.3	. . .
New	Total												30,401	23,249	–23.5	
Old	Hidro	Bocones	USD	. . .	12	2,986.9	12/2/1992	12/2/2008	16.0	7.5	Y	Y	26.8	19.5	–27.2	46
Old	Pre 3$	Bocones	ARS	. . .	12	1,973.4	9/1/1992	9/1/2002	10.0	1.2	Y	Y	130.7	48.1	–63.2	131
Old	Pre4 USD	Bocones	USD	2.00	12	3,161.9	9/1/1992	9/1/2002	10.0	1.2	Y	N	54.6	21.6	–60.4	304
Old	Pro1 $	Bocones	ARS	. . .	12	7,694.4	4/1/1991	4/1/2007	16.0	5.8	Y	Y	1,426.3	817.3	–42.7	1,545
Old	Pro2 USD	Bocones	USD	2.00	12	2,412.8	4/1/1991	4/1/2007	16.0	5.8	Y	Y	242.9	144.5	–40.5	254
Old	Pro3 $	Bocones	ARS	. . .	12	5.6	12/28/1994	12/28/2010	16.0	9.5	Y	Y	0.9	0.6	–33.3	1
Old	Pro4 USD	Bocones	USD	2.00	12	915.2	12/28/1994	12/28/2010	16.0	9.5	Y	N	81.4	70.4	–13.5	97
Old	Pro5 $	Bocones	ARS	. . .	4	455.0	1/15/1999	4/15/2007	8.3	5.8	Y	Y	126.3	78.3	–38.0	193
Old	Pro6 USD	Bocones	USD	2.00	4	1,120.4	1/15/1999	4/15/2007	8.3	5.8	Y	N	131.1	93.4	–28.8	160
Old	Bonex 92	Bonex	USD	. . .	2	2,500.0	9/15/1992	9/15/2002	10.0	1.2	Y	Y	404.4	95.0	–76.5	423
Old	Bonte 02	Bontes	USD	8.75	2	2,682.6	5/9/1997	5/9/2002	5.0	0.9	N	N	248.4	238.4	–4.0	311
Old	Bonte 03	Bontes	USD	11.75	2	2,820.7	2/21/2000	5/21/2003	3.3	1.9	N	N	532.6	512.3	–3.8	615
Old	Bonte 03 F	Bontes	USD	. . .	4	1,078.3	7/21/1998	7/21/2003	5.0	2.1	N	Y	485.3	457.5	–5.7	487
Old	Bonte 04	Bontes	USD	11.25	2	2,897.8	5/24/1999	5/24/2004	5.0	2.9	N	N	987.7	910.6	–7.8	1,104
Old	Bonte 05	Bontes	USD	12.13	2	2,609.2	2/21/2000	5/21/2005	5.3	3.9	N	N	1,113.4	1,013.1	–9.0	1,270
Old	Bonte 06	Bontes	USD	11.75	2	2,608.1	2/21/2001	5/15/2006	5.2	4.9	N	N	1,751.9	1,515.4	–13.5	1,868
Old	Bonte 27	Bontes	USD	9.94	2	1,127.4	10/23/1998	9/19/2027	28.9	26.3	N	N	972.1	678.1	–30.2	974
Old	RA $ 02	Eurobonds	ARS	8.75	2	500.0	7/10/1997	7/10/2002	5.0	1.1	N	N	157.2	147.3	–6.3	181
Old	RA $ 07	Eurobonds	ARS	11.75	2	500.0	2/12/1997	2/12/2007	10.0	5.6	N	N	323.4	265.2	–18.0	380
Old	FRAN	FRAN	USD	. . .	2	1,000.0	3/27/1998	4/10/2005	7.0	3.8	N	Y	544.5	506.4	–7.0	756
Old	FRN2004	FRAN	USD	. . .	4	300.0	3/15/1999	4/6/2004	5.1	2.8	N	Y	69.1	62.2	–10.0	190
Old	FRBs	FRB	USD	2.00	2	8,466.5	11/5/1993	3/29/2005	11.4	3.8	Y	Y	1,714.6	971.1	–43.4	2,071
Old	Disc	Global	USD	2.06	2	4,135.9	4/7/1993	3/31/2023	30.0	21.8	N	Y	550.8	418.6	–24.0	568
Old	GL 03	Global	USD	8.38	2	2,050.0	12/20/1993	12/20/2003	10.0	2.5	N	N	181.1	160.3	–11.5	183
Old	GL 05	Global	USD	11.00	2	1,000.0	12/4/1998	12/4/2005	7.0	4.5	N	N	46.4	40.9	–11.9	77
Old	GL 06	Global	USD	11.00	2	1,300.0	10/9/1996	10/9/2006	10.0	5.3	N	N	77.8	66.5	–14.5	91
Old	GL 09	Global	USD	11.75	2	1,500.0	4/7/1999	4/7/2009	10.0	7.8	N	N	336.6	270.9	–19.5	433
Old	GL 10	Global	USD	11.38	2	1,000.0	3/15/2000	3/15/2010	10.0	8.7	N	N	139.9	110.2	–21.2	216

Old	GL 12	Global	USD	12.38	2	1,594.0	2/21/2001	2/21/2012	11.0	10.7	N	N	689.0	565.0	–18.0	753
Old	GL 15	Global	USD	11.75	2	2,402.7	6/15/2000	6/15/2015	15.0	14.0	N	N	1,499.8	1,188.6	–20.7	1,918
Old	GL 17	Global	USD	11.38	2	4,575.0	1/30/1997	1/30/2017	20.0	15.6	N	N	2,084.0	1,646.3	–21.0	2,170
Old	GL 19	Global	USD	12.13	2	1,433.5	2/25/1999	2/25/2019	20.0	17.7	N	N	1,257.0	1,030.8	–18.0	1,306
Old	GL 20	Global	USD	12.00	2	1,250.0	2/3/2000	2/1/2020	20.0	18.6	N	N	1,091.9	889.9	–18.5	1,105
Old	GL 27	Global	USD	9.75	2	3,435.1	9/19/1997	9/19/2027	30.0	26.3	N	N	2,543.8	1,774.3	–30.3	2,683
Old	GL 30	Global	USD	10.25	2	1,250.0	7/21/2000	7/21/2030	30.0	29.1	N	N	1,009.5	711.7	–29.5	1,116
Old	GL 31	Global	USD	12.00	2	1,175.0	1/31/2001	1/31/2031	30.0	29.6	N	N	1,159.8	939.4	–19.0	1,175
Old	Par	Global	USD	6.00	2	12,489.0	4/7/1993	3/31/2023	30.0	21.8	N	N	1,823.4	1,267.2	–30.5	1,973
Old	BP E+330	Pagares	USD	E+330	12	400.0	8/22/2000	8/22/2002	2.0	1.2	N	Y	223.6	217.4	–2.8	343
Old	BP E+400	Pagares	USD	E+400	12	400.0	4/24/2000	4/24/2002	2.0	0.8	N	Y	308.8	304.0	–1.6	359
Old	BP E+435	Pagares	USD	E+435	12	150.0	2/16/2001	2/16/2004	3.0	2.7	N	Y	101.5	96.7	–4.7	128
Old	BP E+580	Pagares	USD	E+580	12	1,200.0	10/30/2000	10/30/2002	2.0	1.4	N	Y	1,193.0	1,208.3	1.3	1,193
Old	BP B+410	Pagares	USD	B+410	12	1,184.8	11/2/1999	11/2/2001	2.0	0.4	N	Y	20.2	20.0	–1.0	5
Old	BP B+500	Pagares	USD	B+500	12	111.5	7/14/1999	7/14/2001	2.0	0.1	N	Y	0.6	0.6	0.0	23
Old	BP E+521	Pagares	USD	E+521	12	21.5	11/2/1999	11/2/2001	2.0	0.4	N	Y	1,083.8	1,098.9	1.4	1,084
Old	BP E+600	Pagares	USD	E+600	12	820.2	7/14/1999	7/14/2001	2.0	0.1	N	Y	527.5	538.4	2.1	528
Old	SPAN 02	Span	USD	0.00	2	500.0	12/16/1997	11/30/2002	5.0	1.4	N	N	18.4	18.0	–2.2	28
Old	Total					95,194							29,493.8	23,249.2	–21.2	

Sources: Bloomberg and Argentina, Ministry of Economy and Production.
Note: Y = Yes; N = No.

debt swaps transacted at current market yields, do not work during a crisis. This follows from the voluntary or market-based nature of such operations, which implies that they are by definition NPV-neutral. But interest rates are typically higher during crisis, and any NPV-preserving transformation of cash flows made at higher rates would mean a much higher debt-service burden calculated at more normal rates and serves to worsen debt sustainability.

Voluntary debt swaps (and debt buybacks) done during a crisis can be likened to the case of an individual who, unable to service mortgage undertaken when interest rates were low, decides to refinance it at a much higher interest rate in exchange for temporary relief. The mega-swap involved a relief of $15 billion in undiscounted cash payments for five years in exchange for a commitment to increase Argentina's debt payments by an undiscounted amount of $65 billion. At a more normal and sustainable discount rate of 12 (7) percent, this implied an increase of about $1.3 billion ($10 billion) in the NPV value of debt. It thus significantly worsened Argentina's already shaky debt sustainability.

If a voluntary debt swap is expensive, why would any country want to do it? There are two considerations. First, for a country experiencing an acute liquidity shortage, the only alternative to a market-based debt swap is either to declare an immediate default or to restructure its debt on nonmarket terms. If the country believes that it has no solvency problem, it may be willing to pay the price to avoid the immediate default. Second, the potential macroeconomic gain from improved liquidity from a swap can be large (if the country remains solvent),[3] while the country does not have to make a full payment on the restructured debt if it is in fact insolvent. A country in a desperate situation thus has a strong incentive to "gamble for redemption," by paying for an expensive debt swap in hopes of obtaining a high-return outcome that may have a low probability.

[3]Cline (2003), for example, argues that if the swap had been successful and Argentina had avoided the default, the benefit would have been at least $45 billion, an amount of lost output in 2002 resulting from the default and devaluation.

Appendix 8

Financial Instruments Used by Argentina During the Crisis

As alternatives to official financing and payment standstills, a number of financial instruments have been proposed to deal with an acute liquidity need during crisis. These include: (i) *voluntary debt restructuring operations*—buybacks and swaps—without official enhancements; (ii) *public guarantees and other enhancement* to induce the provision of private financing; and (iii) *private contingent credit lines*. Argentina made use of all of these tools during 1999–2001. In the text, as well as in Appendix 7, we discuss voluntary debt swaps without official enhancements (as in the mega-swap of June 2001). In this appendix, we discuss the usefulness of official enhancements and guarantees to either induce new financing or achieve debt reduction, as well as of private contingent credit lines to help improve liquidity and debt sustainability.[1] We will show that, as with voluntary debt restructuring, these instruments do not work under crisis conditions. A general lesson is that attempts at financial engineering when a country has severe debt servicing problems are futile. If debt is unsustainable, debt restructuring with a meaningful NPV reduction can only restore sustainability.

Guarantees and Enhancements

A number of proposals have been made to mobilize emergency liquidity from private creditors by providing an official guarantee or by using official resources to enhance a debt swap or buyback. The idea is to give private creditors access to the same preference in repayment given to official creditors, or to "enhance" private lending by using official resources to finance a debt buyback or a debt swap. Argentina used both forms of enhancement, the first in the case of the World Bank policy-based guarantee (PBG) loan and the latter in the failed attempt to reduce its debt burden in the fall of 2001 with the $3 billion set aside for debt operations in the September augmentation. We will consider each in turn.

A private loan with a partial official guarantee

Partially guaranteed instruments are typically priced by the market as being a combination of two components: a guaranteed loan, which is valued as G-7 or World Bank risk; and an unguaranteed loan, which is valued as pure country risk. The guaranteed portion provides a financial benefit to the debtor, since the guarantee allows a risky country to borrow at a risk-free rate. But apart from this subsidy, no extra value is created by blending together a guaranteed and an unguaranteed bond. In fact, an instrument that combines a guaranteed portion and an unguaranteed portion is usually valued by the markets as being worth slightly less than a separate World Bank bond and a separate unguaranteed country bond. A $3 billion guarantee for a $6 billion bond is very similar to being able to borrow $3 billion from the official sector and $3 billion from private creditors.

Various proposals have been made to create partial guarantees that produce "more bang for the buck." In most cases, proponents argue that while the guarantee formally and legally covers a portion of the cash flow, the "halo" of the guarantee from an official creditor will fall on the entire loan. Official "pixie dust" will lower the spread on the uncollateralized component of the loan, since the debtor will be less inclined to default on even the unguaranteed payments. In practice, however, even attempts to create more complex structures designed to convince investors that the amount of de facto protection provided by the limited guarantee far exceeds the size of the formal guarantee have proven futile.

The most ingenious structure is a so-called rolling reinstatable guarantee, in which the World Bank guarantees the first payment of a bond. The guarantee is rolled to the next payment if the country has made the first payment. If the country cannot pay the guaranteed tranche, the World Bank would pay and the country will have a brief period of time to repay the World Bank. So long as the country is able to come up with the funds to repay the World Bank, the guarantee is "reinstated" and rolled to the next payment. The idea is simple: the country would not want to default on the World Bank, so the guarantee

[1]This discussion relies in part on a more detailed treatment in Roubini and Setser (2004).

would almost certainly roll over and eventually cover the full bond. While the World Bank only formally guarantees the first payment, the "halo" of the guarantee would extend to the entire instrument.[2] In practice, however, the market has priced the bonds issued with such guarantees more like a single guaranteed bond and a series of unguaranteed bonds. This structure has never offered a realistic means of allowing countries experiencing liquidity problems during a crisis to raise funds at guaranteed interest rates.

Argentina was one of the countries to experiment with this structure. When Argentina missed the guaranteed payment on its rolling reinstatable bond, the World Bank stepped in to make that payment, and Argentina in turn increased its obligations to the World Bank by the amount the World Bank had paid on the guarantee. That was the easier part. The hard part was to decide whether or not to pay back the World Bank in time to allow the guarantee to be "reinstated" and then "roll" on to the next payment. At the advice of the World Bank, Argentina opted not to pay the Bank within the designated period, ending any chance that the guarantee would be "reinstated" and the formally unguaranteed balance would be protected. This incident assured that this structure would never be viewed again by the markets as conferring a "halo," and served to confirm the real risks associated with reinstatable guarantees. In a crisis, the official sector and the country must decide if the pixie dust is real: there is no room for ambiguity. Had the bond been honored in full, Argentina would have ended up in the worst of both worlds. It would have paid a higher rate for borrowing through this complex structure than for borrowing directly from the World Bank, yet ex post it would have treated the bond like other low-cost multilateral development bank debt. As it turned out, it was the creditors, rather than Argentina, that lost out.

Debt buybacks or swaps partially enhanced by official resources

A related issue is whether official enhancements can be used to reduce the debt burden of a country experiencing liquidity and debt sustainability problems. Use of official money to reduce debt burden was the idea behind the $3 billion set aside for debt operations in the September 2001 augmentation for Argentina. We have already noted in the text that market-based voluntary swaps during a crisis would make the situation worse by increasing the real debt burden. The issue here is whether adding enhancements to such deals (that is, moving from a voluntary mega-swap in June to a $3 billion enhanced swap or buyback in the fall) makes them more attractive. The simple answer is no. As articulated by the classic analysis of Bulow and Rogoff (1988, 1989), using official resources to buy back debt increases the residual value of the remaining debt and does not affect at all the debt burden of the debtor: all of the gains from official enhancements go to the creditors rather than the debtor. While there is a long academic debate on this "debt buyback boondoggle" result,[3] and results on the distribution of the gain between the debtor and creditors may marginally change depending on various analytical assumptions, it is clear that the proposal to use $3 billion of official money to make the debt of Argentina sustainable did not make sense.

The argument is as follows. In the summer of 2001, $3 billion could have bought back $4 billion of short-term debt (trading at 75 cents on the dollar) or $6 billion of long-term debt (trading at about 50 cents on the dollar). In cash flow terms, the latter solution did not give much liquidity relief, as coupons closer to 10 percent on old long-term bonds would have been exchanged with lower interest rates (say 4 percent) on the $3 billion provided by the IMF, yielding a total annual saving of $180 million. The former solution, assuming that the IMF loan was to be repaid four years later, would have provided a cash flow relief in principal of $4 billion right away in exchange of interest payments on the IMF loan and repayment of $3 billion four years later. So, while the short-run cash flow relief was larger, the effect on the stock of debt of Argentina and its debt sustainability was practically nil. With a stock of external debt around $100 billion, such an operation would have reduced the stock by at most $3 billion. Thus, either way, use of official money would not have affected the debt sustainability of Argentina.

In this regard, larger loans or other uses of official money would have made little difference. Taking a larger short-term loan (even at subsidized rates) to reduce a larger amount of longer-term debt has little NPV effect on debt apart from the subsidy value of official money. Likewise, using the $3 billion for partial guarantees on a debt swap instead of a buyback would have had little or no effect on debt sus-

[2]Had this structure worked as advertised, the combined instrument would be worth more than the sum of its parts. But even here, the structure is not really creating value. Rather, the structure is effectively transferring value from other unguaranteed bonds to the holders of the partially guaranteed bond. The holders of the nonguaranteed part of the partially guaranteed bond benefit because their claims are being given seniority relative to other nonguaranteed claims, but it would be more efficient to provide seniority explicitly.

[3]See the exchange between Sachs (1988) and Bulow and Rogoff (1988, 1989). A good survey of this debate is provided in Cline (1995).

tainability. In all these cases, the NPV benefit is the difference between the interest rate on the retired debt relative to the official interest rate times the amount of official money. Even at yields of 15 percent, borrowing say $10 billion from the IMF at 4 percent for one year implies a NPV benefit of about $1.1 billion, practically nothing compared to the external debt of over $100 billion.

Private Contingent Credit Lines

There is another approach to obtaining liquidity during a crisis: pay for it in advance. A country can buy the right to borrow from a group of banks in the event of trouble. The particular details of such a contingent credit line can vary, but the simplest contingent credit line would give the government the right to borrow a predetermined amount at a fixed interest rate at a time and place of the government's choosing. For this service, the banks would receive a fee in return. Contingent credit lines can be thought of as a substitute for reserves. Instead of holding reserves "on balance sheet," contingent credit lines provide "off balance sheet" reserves. The fee the banks charge can be compared to the cost of paying holding reserves—typically a difference between the country's cost of funds and the risk-free interest rate they earn on their reserves.

Unfortunately, actual experience with private contingent credit lines has been dismal, and such facilities hardly offer a viable substitute for official financing. Back in 1997, three countries—Mexico, Indonesia, and Argentina—had access to private contingent credit lines. All three countries eventually drew on their credit line, and in no case was the experience a happy one for the country or for its bankers.

Argentina's credit line was intended to provide liquidity to the banking system rather than to the government. In this arrangement, the central bank bought the right to sell (with a promise to repurchase) the banking system's holdings of Argentina's international bonds in return for cash. This facility, however, failed to work as designed when Argentina's banking system experienced severe stress in 2001. The authorities feared that drawing on the facility would trigger the bank run the facility was meant to deter. The banks were quite keen to get out of this commitment as the public finances deteriorated. When the mega-swap of June retired many of the bonds that were eligible to be "repo'ed" for cash, it effectively reduced the size of the facility. Argentina did draw on the credit line in September 2001, but it opted not to obtain the maximum possible sum. It obtained $1.5 billion from private creditors and an additional $1.0 billion from World Bank and IDB enhancements that were part of the facility. At any rate, the credit line was too small to provide the sums Argentina needed.

The net amount of additional financing that these facilities provide in a crisis is difficult to assess: the banks will take steps to hedge the risks associated with their commitment to lend to a crisis country. Some hedges—like shorting the country's external debt—would put pressure on secondary market prices but do not directly result in pressure on the country's reserves. Other potential hedges, such as reducing the local exposure of their affiliates in the debtor country, can put pressure on the country reserves. One virtue of the official sector is that it does not seek to hedge its crisis lending and truly provides net new financing.

Appendix 9

Timeline of Selected Events, 1991–2002

Date	Events
1/30/91	Domingo Cavallo takes office as Minister of Economy. An exchange rate band is established, with the lower band of 10,000 australes and the upper band of 8,000 australes to the dollar.
3/27/91	Argentina, Brazil, Paraguay, and Uruguay sign treaty establishing Mercado Común del Sur (MERCOSUR).
3/28/91	The Convertibility Law is approved by Congress.
4/1/91	The Convertibility Law takes effect, with the parity of 10,000 australes per dollar.
7/29/91	IMF Executive Board approves Stand-By Arrangement with Argentina.
11/1/91	President Carlos Menem announces a broad program of economic deregulation and trade liberalization.
11/14/91	The Employment Law is approved by Congress, authorizing temporary contracts and capping indemnity.
1/1/92	The peso replaces the austral at the conversion rate of 10,000 australes per peso.
3/31/92	IMF Board approves extended arrangement with Argentina.
5/27/92	Port services are privatized by decree.
9/23/92	The new Central Bank Law is approved by Congress, establishing independence and mandating price stability as its primary objective.
9/24/92	Sale of State Oil Company (YPF) is authorized by law.
11/9/92	First general strike is organized by labor unions against President Menem.
11/11/92	An agreement is reached with creditor banks.
12/6/92	Argentina enters the Brady Plan. The IMF Managing Director congratulates Argentina on the agreement.
1/4/93	Use of dollars for current and checking accounts is authorized.
1/20/93	Last day to exchange australes for new pesos.
3/10/93	The Radical party, labor unions, and retirees demonstrate in protest of the pension reform.
3/16/93	Peronist governors approve the constitutional reform, allowing a second presidential term.
9/23/93	Senate approves the pension reform law.
10/3/93	Lower House elections. Peronists increase seats in Congress.
11/14/93	Olivos Pact: Carlos Menem of the Peronist party and Raúl Alfonsín of the Radical party reach agreement on the framework for constitutional reform, allowing a second presidential term of four years.
8/1/94	Constitutional Convention approves the new Constitution.
8/4/94	MERCOSUR is created, comprising Argentina, Brazil, Paraguay, and Uruguay.
11/22/94	Senate approves the privatization of Encotesa (Federal Post and Telegraph Company).
12/23/94	Mexico devalues its currency.
1/1/95	MERCOSUR comes into effect.
3/11/95	VAT rate is raised to 21 percent from 18 percent.
3/27/95	IMF Executive Board approves extension of Argentina's extended arrangement.
4/14/95	Government suspends five banks with liquidity problems.
5/14/95	Presidential elections. Carlos Menem is reelected as President.
11/29/95	Lower House grants Minister Cavallo special powers for a year to balance federal budget.
4/12/96	IMF Executive Board approves Stand-By Arrangement with Argentina.
7/18/96	Minister Cavallo threatens to resign if his fiscal adjustment program is not approved.
7/26/96	Domingo Cavallo is replaced by Roque Fernández as Minister of Economy.

Date	Events
7/29/96	Minister Fernández formally takes office.
1/2/97	A judge declares the labor reform decree unconstitutional.
3/24/97	Postal system is privatized by decree.
4/9/97	Press reports of increasing tension between President Menem and Governor Duhalde.
4/24/97	National and provincial airports are privatized by decree.
5/9/97	A labor reform plan is agreed with unions, introducing flexibility in labor contracts, but protecting union medical systems from competition.
8/2/97	The Radical and FREPASO parties make an alliance, subsequently to be known as the *Alianza*.
8/14/97	National strike is called.
9/15/97	President Menem promises an increase in pension benefits.
9/21/97	President Menem promises an increase in teachers' pay.
11/19/97	*Alianza* expresses public support for the convertibility regime.
2/4/98	IMF Board approves extended arrangement with Argentina.
2/17/98	Eduardo Duhalde relaunches his candidacy for 1999 presidential elections.
2/20/98	Press reports of accord between Governor Duhalde and President Menem.
3/28/98	*Alianza* launches a campaign against a second presidential reelection.
4/3/98	Fernando De La Rúa is proclaimed presidential candidate for 1999 elections in Radical party convention.
4/21/98	Eduardo Duhalde reaffirms his candidacy for 1999 presidential elections.
7/8/98	*Alianza* rejects the labor reform plan.
7/12/98	President Menem seeks Peronist support for a popular referendum regarding a second reelection. The idea is rejected by both the *Alianza* and the Peronist party.
7/17/98	President Menem seeks Peronist support for a second reelection. Press reports of a split in the party.
7/25/98	Eduardo Duhalde launches his presidential campaign and affirms the need for a change in the economic model.
9/2/98	Labor reform is approved by Congress and becomes law.
10/1/98	The IMF Managing Director praises the Argentine economy.
10/5–7/98	President Menem attends the IMF–World Bank Annual Meetings.
10/9/98	President Menem reaffirms his desire for a second reelection term.
11/29/98	Fernando De La Rúa wins the nomination of the *Alianza* as presidential candidate.
12/2/98	Carlos Álvarez is chosen as the *Alianza's* vice presidential candidate.
12/5/98	Press reports that President Menem seeks a constitutional reform but faces stiff opposition.
1/11/99	The court denies President Menem constitutional permission for a second reelection.
1/13/99	Brazil devalues its currency.
1/15/99	Press reports of President Menem reaffirming commitment to maintain the peso-dollar parity.
2/8/99	Press reports of President Menem proposing dollarization.
2/27/99	President Menem reportedly withdraws his bid to run for the presidential election.
4/16/99	Domingo Cavallo is reported to suggest a need to modify the convertibility regime.
5/12/99	Minister Fernández demands agreement with Congress to guarantee fiscal solvency.
7/14/99	Governor Duhalde is reported to consider debt restructuring.
10/24/99	Presidential and Lower House elections. Fernando De La Rúa and Carlos Álvarez of the *Alianza* win, with 48.5 percent of the votes. *Alianza* increases its seats to 125 (from 105), while the Peronist party retains 101 seats, a loss of 19 seats.
12/10/99	De La Rúa takes office as Argentina's president, with José Luis Machinea as Minister of Economy.
2/24/00	A strike is called against the labor market reform proposal, stipulating decentralization of collective labor contracts.
3/10/00	IMF Board approves Stand-By Arrangement with Argentina.
4/26/00	Labor reform is approved by the Senate with some modifications. Labor unions call for a national strike.
5/5/00	A national strike is called against the labor reform.
5/11/00	Labor reform is approved by the Lower House and becomes law.
6/6/00	A national strike is called.
8/17/00	Responding to public denunciations, President De La Rúa creates a special commission, chaired by Vice President Carlos Álvarez, to investigate the bribery charges associated with the Senate approval of the labor reform law.
9/4/00	President De La Rúa affirms that the government has not paid bribes to get the labor reform law approved.

Date	Events
10/6/00	Vice President Carlos Álvarez resigns.
1/12/01	IMF Board approves augmentation of Stand-By Arrangement and completes second review.
3/2/01	Minister Machinea resigns.
3/4/01	Ricardo López Murphy is appointed Minister of Economy.
3/16/01	FREPASO members of the cabinet resign in protest over a proposed fiscal austerity program. Alliance between the FREPASO and the Radical party is broken. Labor unions call for a strike.
3/19/01	Minister López Murphy resigns.
3/20/01	Domingo Cavallo is appointed the new Minister of Economy.
3/26–28/01	International rating agencies lower Argentina's long-term sovereign rating.
3/29/01	Minister Cavallo secures "emergency powers" from Congress.
4/14/01	Minister Cavallo announces a modification of the convertibility law, with the replacement of the dollar by an equally weighted basket of the dollar and the euro.
4/16/01	Minister Cavallo requests major businesses to purchase "patriotic bonds" for $1 billion.
4/26/01	The Central Bank Governor is replaced over alleged money laundering charges.
5/8/01	Standard & Poor's lowers Argentina's long-term sovereign rating further from B+ to B.
5/21/01	IMF Board completes third review of Argentina's Stand-By Arrangement.
6/3/01	Authorities announce the completion of the "mega-swap."
6/15/01	Minister Cavallo announces package of tax and trade measures, including a trade compensation mechanism for exporters and importers of nonenergy goods.
6/20/01	The Senate approves the revised convertibility law.
7/11/01	A zero deficit plan is announced, with a mandatory reduction in expenditures to balance the budget.
7/30/01	The zero deficit plan becomes law.
8/10/01	Press quotes market sources to report that an IMF package will only delay the default.
8/21/01	IMF announces planned augmentation of Stand-By Arrangement by $8 billion.
9/5/01	Press reports that FREPASO is proposing an end of the convertibility regime.
9/7/01	IMF Board approves augmentation of Stand-By Arrangement and completes fourth review.
10/14/01	Upper and Lower House elections. The Peronist party controls both houses of Congress.
10/30/01	FREPASO breaks the *Alianza* coalition in the Lower House.
11/6/01	Standard & Poor's lowers Argentina's long-term sovereign rating from CC to SD (selective default).
12/1/01	The government introduces a partial deposit freeze (*corralito*) and capital controls.
12/6/01	Minister Cavallo travels to the United States to meet with IMF management.
12/8/01	Private pension funds are forced to buy national bonds.
12/12/01	A national strike is called, setting off a series of demonstrations against the government's economic policies.
12/19/01	Minister Cavallo resigns.
12/20/01	President Fernando De La Rúa resigns over death of demonstrators. Ramón Puerta, President of the Senate, becomes interim President.
12/23/01	Adolfo Rodríguez Saá is elected president by the Legislative Assembly. He announces partial default on external debt.
12/30/01	Rodríguez Saá resigns. Eduardo Camaño, head of Lower House, becomes interim president (as Ramón Puerta resigns as Senate president).
1/1/02	Eduardo Duhalde is elected President by the Legislative Assembly to serve until December 2003.
1/3/02	President Duhalde announces the end of convertibility, and the introduction of a dual foreign exchange regime.
1/6/02	The convertibility law ceases to be in effect. A dual exchange rate regime is introduced, one fixed at 1.40 pesos to a dollar for foreign trade, and the other determined in the free market.
2/3/02	The government decrees the unification of the exchange rate regime and the asymmetric pesoization of bank balance sheets (assets at Arg$1/US$1, and liabilities at Arg$1.40/US$1).
2/11/02	The foreign exchange market opens for the first time under a unified regime; the peso depreciates to Arg$1.8 to the dollar.
3/8/02	The pesoization of government debt under Argentine law is decreed.
3/25/02	The peso reaches a peak of Arg$4 per dollar.

Sources: Pablo Gerchunoff and Lucas Llach, *El ciclo de la ilusión y el desencanto*, Ed. Ariel, 2003; Luis Alberto Romero, *Breve historia contemporánea Argentina*, Fondo de Cultura Argentina, 2001; Luis Alberto Romero, *Argentina: una crónica total del siglo XX*, Ed. Aguilar, 2000; *Anuario Clarín*, various years, Editorial Atlántida; *Clarín*, 1997–2002, on-line version; *La Nación*, 1991–2002, print version; and *La Nación*, 1997–2002, on-line version.

Appendix 10 List of Interviewees

The IEO team has spoken to more than 40 current and former members of IMF management, staff and the Executive Board. In addition, the following individuals have provided their views to the IEO, mostly through personal interviews but also through seminars and workshops. We express our gratitude for their generosity in making their time available to us, and apologize for any errors or omissions. They assume no responsibility for any errors of fact or judgment that may remain in the report.

International and Regional Organizations

World Bank

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European Central Bank

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Georges Pineau
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European Commission

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Inter-American Development Bank

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Organization for Economic Cooperation and Development

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United Nations Economic Commission for Latin America and the Caribbean

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Bernardo Kosacoff
Adrián H. Ramos

Member Country Officials

Argentina

Roberto Arias
Daniel Artana
Luis Alfredo Azpiazu
Jorge Baldrich
Mario Blejer
Darío Braun
Domingo Cavallo
Adolfo Diz
Roque Fernandez
Jorge Gaggero
Marcelo García
Javier González Fraga
Pablo Guidotti
Ricardo Gutiérrez
Alejandro Henke
Miguel Kiguel
Roberto Lavagna
Eduardo Levy-Yeyati
Juan José Llach
Ricardo López Murphy
José Luis Machinea
Daniel Marx
Guillermo Mondino
Santiago Montoya
Guillermo Nielsen
Geraldo Adrián Otero
Eugenio Pendas
Pedro Pou
Andrew Powell
Alfonso Prat-Gay
Jorge Remes Lenicov
Carlos A. Rodríguez
Rodolfo Rossi
H. Horacio Salvador
Federico Sturzenegger
Mario Vicens
Agustín Villar

Other countries

Enrique Alberola Ila
Steve Backes
Andrew Berg
Lorenzo Bini Smaghi
Jasper Blom
Christian Broda
Terrence Checki
John Clark
Stephen Collins
Marco Committeri
Bertrand Couillault
Ralf Debelius
John Drage
Elvira Eurlings
Antonio Fanna
Marco Fauna
Hiroshi Fujiki
Alicia Garcia Herrero
Stéphanie Gaudemet
Giorgio Gomel
Doris Ellen Grimm
Dietrich Hartenstein
Joji Ide
Hirotaka Inoue
Pierre Jaillet
Yukinobu Kitamura
Shuji Kobayakawa
Takayuki Kobayashi
Michael A. P. Kuijper
Haruhiko Kuroda
Chris Kushlis
Renaud Meary
Thomas Melito
Jochen Metzger
Isaya Muto
Stéphane Pallez
Adrian Penalver
Stephen Pickford
Gonzalo Ramos
Tom Rogers
Marc Roovers
Gita Salden
Tetsuya Sato
Stéfan Schoenberg
Claus Schollmeier
Brad Setser
Shigeru Shimizu
Mark Sobel
Marc-Olivier Strauss-Kahn
Wataru Takahashi
John B. Taylor
Gregory Thwaites
Ramin Toloui
Edwin Truman
Jan Willem van der Kaaij
Jose Vinals
Stephan FRHR Von Stenglin
Kiyoshi Watanabe
Claire Waysand
Christiane Welte
Rolf Wenzel
Dan Zelikow
Vicenzo Zezza

Academics and Other Individuals

Victor Abramovich
Carlos Acuna
Roberto Alemann
Lew Alexander
Martin Anidjar
Makoto Aratake
Ricardo Arriazu
Santiago Bausili
Cosme Beccar Varela
Gavin Bingham
Amer Bisat
Jorge Blazquez-Lidoy
Paul Blustein
Miguel Angel Broda
Mario Cafiero
Gustavo Canonero
Ariel Caplan
Lisandro Catalan
Menzie Chin
Eduardo Conesa
Osvaldo Cornide
Eduardo Curia
Eduardo de la Fuente
Horacio Delguy
José Ignacio de Mendiguren
Edvardo Di Cola
Rafael Di Tella
Carlos Domene
Carlin Doyle
Sebastian Edwards
Klaus Engelen
Miguel Escrig Melia
José Luis Fabris
Roberto Favelevic
Martin Feldstein
Aldo Ferrer
Kristin Forbes
Rosendo Fraga
Jeffrey Frankel
Roberto Frenkel
Barbara Fritz
Peter Garber
Américo García
Guillermo Gotelli
Geoffrey Gottlieb
Juan José Guaresti
Kenji Haramiishi
Eduardo Helguera
Katja Hujo
Hirotaka Ikeda
Mika Ikeda
Joseph Joyce
Martin Kanenguiser
Isao Kawanabe
Severo Lanz
Guillermo Laura
Andrés Lederman
Paulo Leme
Fernando Daniel López
Fernando Losada
Francisco Matilla
Antonio Merino García
Juan Antonio Mielgo
Hugo Moyano
Arnaldo Musich
Jujio Namiki
Arturo O'Connell
Federico Palacio
Celedonio Paneda
Arturo Porzecanski
Carla Gabriela Raimondi
Alberto Ramos
Moises Resnick Brenner
Osvaldo Rial
Dani Rodrik
Luigi Ruggerone
José Juan Ruiz
Rodolfo Santangelo
Naoki Sawaoka
Miguel Sebastian
Dennis Sertcan
Takeshi Shigeoka
Dante Simone
Kenichi Suzuki
Naoyuki Takashina
Shin Takehara
Masaharu Takenaka
Mariano Tommasi
Juan Carlo Torre
Gerardo Tresca
Héctor Valle
Andrés Velasco
Motoyasu Yokota
Yorikatsu Yoshida

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Statement by the Managing Director

IMF Staff Response

IEO Comments on Management/Staff Response

Statement by the Governor for Argentina

Summing Up of IMF Executive Board Discussion by the Chairman

Statement by the Managing Director on the Evaluation by the Independent Evaluation Office of the Role of the Fund in Argentina, 1991–2001

Executive Board Meeting
July 26, 2004

In its report on Argentina, the Independent Evaluation Office (IEO) has examined an important country case to shed fresh light on the experience of IMF-supported programs and surveillance. The report is thoroughly researched and insightful. It once again confirms the valuable role played by the IEO in enhancing the learning culture of the institution.

I find most of the analysis in the report convincing and generally welcome the recommendations. I have asked staff to prepare a statement providing a more detailed response to the report and recommendations. I look forward to the Board discussion of the paper, which will provide the opportunity for Executive Directors to consider the implications of these recommendations for the institution.

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*.[1] 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-

[1]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[2]—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 regard 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

[2]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.[3] 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 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.[4] 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.[5] 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.[6] 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.[7] 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

[3]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).

[4]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).

[5]"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.

[6]IMF, *World Economic Outlook*, *September 2003,* Chapter III.

[7]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.

Independent Evaluation Office Comments on Management/Staff Response to the Evaluation of the Role of the Fund in Argentina, 1991–2001

Executive Board Meeting
July 26, 2004

We would like to offer a few points of clarification, in response to the comments made by management and staff on the IEO report, focusing on the most critical issues.

The staff suggests that the evaluation report is inconsistent between its assessment of the IMF's decision in late 2000/early 2001 and the lesson it draws from this assessment (para. 5). An inconsistency arises only if one believes that the outcome depended solely on economic fundamentals. This is not the view we take. We believe that investor expectations played a critical role and that, in addition to serious concerns about the fundamental sustainability of both the exchange rate and the debt, there was a self-fulfilling aspect to the crisis. If there were indeed multiple equilibria, one can then argue that the catalytic approach, supported by strong policy action, could have affected investor confidence so favorably as to reverse capital outflows. Our assessment of the IMF's initial approach—that it was worth trying in light of the very high costs of the alternative—follows from this reasoning. In the event, this strategy failed when the agreed policy correction was not made, from which we draw a lesson that the catalytic approach to affect investor expectations has a low probability of success when there are fundamental sustainability problems and the political ability of the authorities to deliver the needed policy correction is weak. Our assessment is a probabilistic one (based on the information available at the time the decision was made), while the lesson necessarily benefits from hindsight.

Regarding Recommendation 1, the staff notes some obstacles to making stop-loss rules operational (para. 10). We agree with much of this argument, but three points deserve emphasis. First, a stop-loss rule is meaningful only if it is part of an overall crisis management strategy tailored to each case. Second, discretion can be a double-edged sword. Discretion can, for example, make it more difficult for the IMF to refuse a member country's request for exceptional support even when the situation seems irretrievable. Conversely, it may induce the country to keep postponing the needed adjustment, in the hope that the favor would be extended over and over again. Third, a stop-loss rule can help focus attention on sustainability, which goes beyond policy performance or effort. In the case of Argentina, throughout the spring and summer of 2001, the IMF continued to provide support on the basis of what it perceived to be the strength of the authorities' resolve, when by that point nothing short of a different strategy could fundamentally solve Argentina's economic problems.

Finally, the staff suggests that the evaluation report understates the informal channels of communication by which information is made available to the Executive Board (para. 4). It is worth emphasizing that the IEO obtained, from varied sources, a large number of notes and reports prepared on all relevant informal Board meetings. What the IEO lacked was access to the informal exchanges that may have taken place between management and individual or subgroups of Executive Directors. Such exchanges, however, cannot be construed as constituting the information provided to the Board.

Statement to the Executive Board Members from the Governor for Argentina, His Excellency Roberto Lavagna, on the IEO Evaluation of the Role of the Fund in Argentina, 1991–2001

Executive Board Meeting
July 26, 2004

Introduction

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

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

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

Surveillance and Program Design

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

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

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

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

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

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

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

which a flexible exchange rate system was a constituent part.

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

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

Crisis Management

Turning now to crisis management, this is clearly the most difficult problem to address given the interplay of economic, political, and social factors involved. In the first place, and from a purely economic point of view, to make an assessment if a member is facing a *liquidity versus solvency* problem is never straightforward. At times, some doses of brinkmanship are needed to direct a situation towards the best possible outcome. On other occasions, as in the Argentine case, an early withdrawal of support could have diminished the consequences of a crisis. In fact, the earmarked funds of the 2001 packages should have been applied to finance a faster and more efficient exit from the CBA.

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

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

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

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

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

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

Political factors also serve to show the complexity and uniqueness of the Argentine case. Although the idea of full dollarization was rejected, the population at large remained largely in favor of the convertibility regime, to the extent that the presidential elections of 1999 were won by the alliance of parties that held the maintenance of the CBA as an essential ingredient of its economic program. On the other hand, a critical mass of political actors, including union leaders and some prominent leaders of the government that took office in December 1999, started to be outspokenly against the CBA exchange regime. Thus, the political backing was weakening. However, the complexity of the Argentine case, from the political point of view, becomes even more evident when observing the overwhelming support the government received in Congress to pass very demanding laws in the spring of 2001, including the granting of special taxation powers to the Executive branch and the zero deficit law that gave the government ample powers to take whatever measure was deemed necessary to revamp confidence and avoid the change of economic model. This was insufficient, nonetheless, to reverse the self-reinforcing dynamic unleashed during the whole of 2001, which, as it is now clear, found its roots in the weaknesses of the model from its beginning in the early 1990s.

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

The Decision-Making Process

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

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

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

It is important, however, to analyze the interesting observation in the report regarding the *behavior of developing countries* in the Board which, as the report says, as "potential borrowers," usually go along with management proposals to support a member country. Reality is more complex than this, and several other factors have a bearing on developing countries' behavior at the Board. For instance, given the limited available resources of the Fund (their relative importance vis-à-vis the international capital markets is ever shrinking), one would expect "potential borrower countries" to advocate limiting the granting of packages to relevant *competing* "fellow borrowers." Additionally, if the report's view were to be taken as a premise of the analysis, then much of the recommendation presented in the report on the need for greater Board participation in the decision-making process would be inconsequential. The outcome would seldom be different since developing countries, according to the report, would always side with management, which in turn tries to incorporate the views of major shareholders. In our view, however, developing countries are quite capable of forming independent views from those of management, particularly when provided with relevant information, and we therefore see merits in the report's recommendations for a more participative decision-making process on the part of developing countries as well as others that may not have the same opportunities to present their views directly to management.

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

Conclusions

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

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

The Chairman's Summing Up

Independent Evaluation Office Report on the Role of the Fund in Argentina, 1991–2001

Executive Board Meeting
July 26, 2004

Executive Directors commended the Independent Evaluation Office (IEO) for preparing a balanced and comprehensive report on the Fund's role in Argentina during 1991–2001. They noted that the report raises important questions about the Fund's engagement during that period, and seeks to draw valuable lessons and recommendations in key areas of the Fund's work, including surveillance, program design and review, and the Fund's decision-making process. Directors welcomed the opportunity to reflect on the report's assessment of that engagement, and agreed that it will be important to set up a process through which the relevant lessons and recommendations could be incorporated into the Fund's operational and policy development work.

Directors recalled that the period covered by the IEO report began with the introduction of the convertibility regime that pegged the Argentine peso at par with the U.S. dollar and ended with that regime's collapse accompanied by a default on Argentina's public debt. The 2001 crisis was one of the most severe in any country in recent years, and brought considerable hardship to the Argentinean people.

Directors generally agreed that the crisis stemmed from the prolonged inconsistency of fiscal policy with the convertibility regime. The primary responsibility for the choice of policies and for economic outcomes remains that of the national authorities, who in this case failed to take the necessary measures sufficiently early to address this inconsistency. The Fund, for its part, erred by supporting Argentina's weak and inconsistent policies for too long, even after it became evident that the political ability to deliver the supporting fiscal discipline and structural reforms was lacking. Directors raised a number of questions about the Fund's decision-making process as it continued to provide support to Argentina. In this connection, some Directors pointed to the challenge of taking difficult decisions in the pressured environment of a rapidly developing crisis.

Directors broadly agreed with the thrust of the lessons and recommendations of the report, which address important weaknesses identified by the IEO in surveillance and crisis management. They cautioned, however, that the applicability of some of the lessons to other crisis situations could be limited, since Argentina is a unique case in many respects. Directors noted also that a number of the report's recommendations are in line with policies and reforms which the Fund adopted following the crises in Argentina and other emerging market countries, but they recognized that further additional work is needed, including on how to ensure that the policies adopted are, in fact, implemented.

With regard to crisis management, Directors discussed the report's recommendation that the Fund should have a contingency strategy from the outset of a crisis, including, in particular, "stop-loss rules" that would help determine if the initial strategy is working and signal whether a change in approach is needed. Most Directors viewed contingency planning as useful, and a few saw merit in setting out an exit strategy if there are indications that the program could become unsustainable. However, many Directors noted that in a crisis or precrisis setting, it is not always possible to assess the various contingencies that might occur, and that an element of prompt adaptation to rapidly evolving events is unavoidable. Concern was also expressed that any indication that the Fund was developing contingency strategies could undermine confidence in the program. Clearly further reflection will be needed in this area to establish what can constructively be done in ways that enhance confidence.

As regards "stop-loss" rules, while some Directors supported their consideration, most felt that defining and implementing such rules would be difficult or impractical. These Directors considered that determining whether the crisis resolution strategy is functioning will invariably depend on judgment and discretion, based on the available information at the

time. Other Directors noted that the Fund's conditionality and program reviews provide a mechanism intended to ensure that the Fund continues to provide its financing only so long as the policies envisaged are being implemented and are on track to achieve their objectives.

Directors agreed with the IEO's recommendation that in cases where the sustainability of debt or the exchange rate is threatened, the Fund should clearly indicate that its support is conditional upon a meaningful shift in the country's policy. At the same time, they noted that assessing sustainability in these two complex areas, particularly in a crisis situation, will necessarily entail judgment. It is essential that the Board be provided with up-to-date and comprehensive information and analysis to make such judgments. Directors recognized that steps have been taken since the Argentine crisis to strengthen the basis on which such assessments are made: in particular, the procedures on exceptional access and the debt sustainability template. At the same time, Directors looked forward to an opportunity to assess whether further changes in the Fund's policies and procedures may be needed.

Directors considered that the Argentine experience had important implications for the Fund's surveillance, an area in which there had been marked progress since the crisis in Argentina. They concurred with the IEO's recommendation that medium-term exchange rate and debt sustainability analyses should form the core focus of IMF surveillance. Directors stressed that the choice of exchange rate regime must remain with the member's authorities, but the Fund is obliged to exercise firm surveillance to ensure that other policies and constraints are consistent with this choice. In this light, Directors continued to see a need—which was emphasized again recently in the Board discussion on the biennial review of surveillance—for greater candor in the treatment of exchange rate policy in the context of Article IV discussions, both in meetings with the authorities and in the information presented to the Board. Most Directors stressed, however, that reports on exchange rate assessments and discussions need to strike an appropriate balance between candor and confidentiality to avoid triggering a potentially destabilizing market reaction. In this connection, it was suggested that the scope for establishing procedures for handling sensitive topics during surveillance exercises should be explored by the staff. On exchange rate sustainability, Directors cautioned that finding an appropriate operational measure would be difficult; however, a few suggested that the development of such a measure by the staff should be a priority.

Directors recognized that the Fund has intensified its analytical work on medium-term debt sustainability. Recent events have led to a reassessment—not only in the Fund, but in the economics profession more generally—of what level of debt is sustainable for emerging market countries, with the concept of "debt intolerance" playing an important role. Such a reassessment is already reflected in the Fund's work with the development of the debt sustainability framework. Directors asked staff to continue to sharpen its analytical tools in this area, and a few called for examining ways to strengthen the organization and independence of DSA work.

Directors noted the possible risks associated with precautionary Fund arrangements, especially where there are serious political obstacles to needed policies and reforms. In cases such as Argentina, where a member's favorable macroeconomic indicators masked underlying structural and institutional weaknesses, it was particularly important to avoid complacency. Most Directors did not think that precautionary arrangements tended to be weaker than other arrangements, noting that in some cases precautionary arrangements signaled superior performance. Directors agreed that there is a need to ensure that program standards and requirements for precautionary arrangements are the same as those for all other arrangements.

Most Directors did not support the implication in the IEO report that the Fund should not enter into a program relationship with a member country when there is no immediate balance of payments need. In their view, the experience of Argentina does not provide a basis for this conclusion, and they reiterated the value of precautionary arrangements as an important tool for supporting sound policies and promoting crisis prevention more generally.

Directors expressed concern about the IEO report's assessment of the quality of cooperation between the Argentine authorities and the Fund, particularly in the period leading up to the crisis. They viewed some of the authorities' actions during 2001 as documented in the report as not conducive to a satisfactory program relationship—particularly their implementation of some key measures without consulting the staff and their refusal to engage the staff on some key areas of policy, notably the exchange rate regime. Many Directors were also concerned that the Board was not kept adequately informed of such breakdowns of cooperation. In this light, Directors stressed that all cases of the use of Fund resources, particularly cases of exceptional access, should entail a presumption of close cooperation, and some Directors suggested that clear guidelines should govern communications by both the authorities and the Fund on program issues. Directors encouraged management and staff to keep the Board fully informed of the state of policy discussions with country authorities in the context of financial pro-

grams, including with regard to any critical issue or information that the authorities refuse to discuss with or disclose to staff and management. Many Directors agreed with the IEO's suggestion that there should be a requirement of mandatory disclosure to the Board of any critical issues which the authorities refuse to discuss.

Directors were concerned with the report's assessment of the Fund's decision-making procedures during the crisis, especially as it pertains to the role of the Board. In this regard, a number of Directors saw a need for further discussion of approaches to strengthen the role of the Board. Directors noted that the procedures for exceptional access adopted since the Argentine crisis have generally worked to strengthen the Board's involvement and ensure that decisions to continue program engagement under exceptional access are adequately informed. At the same time, they called for further efforts to enhance decision making by the Board, including through improvements in the provision of full information on all issues relevant to decision making, and open exchanges of views between management and the Board on all topics, including the most sensitive ones.