

# Executive Summary

**T**he 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.