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.

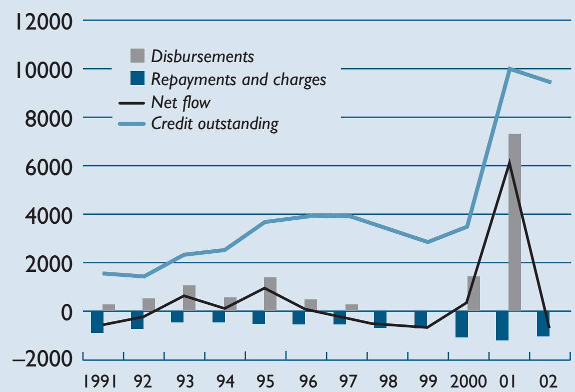
[1]The choice of this period leaves out issues related to the role of the IMF in Argentina's subsequent economic reconstruction and recovery. The IEO's terms of reference do not allow it to evaluate issues that have a direct bearing on the IMF's ongoing operations.

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*.

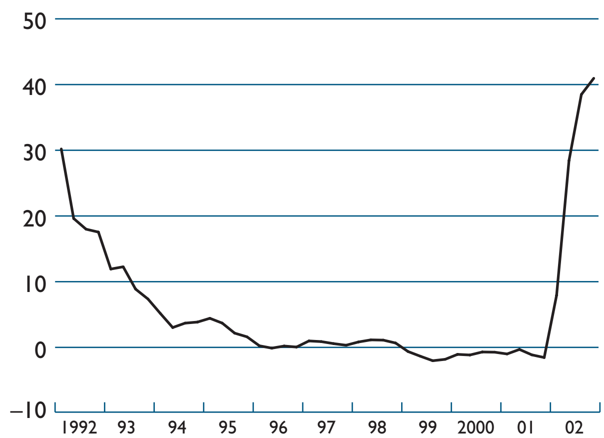
[1]Average of 1990 = 100.

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.

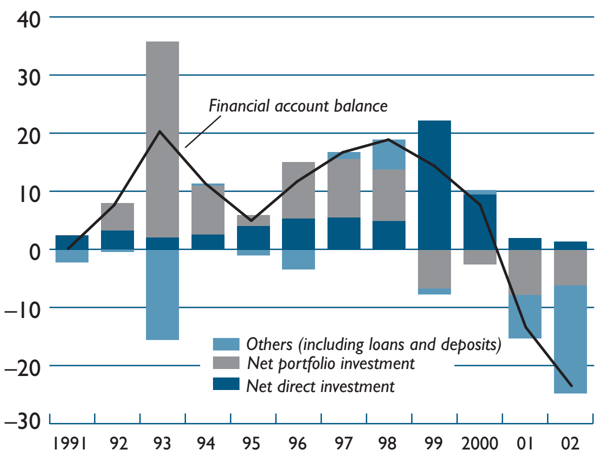
There was a marked improvement in Argentina's economic performance under the Convertibility Plan, particularly during its early years (Table 1.1). Inflation, which was raging at a monthly rate of 27 percent in February 1991, declined to 2.8 percent in May 1991; on an annual basis, inflation fell to single 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

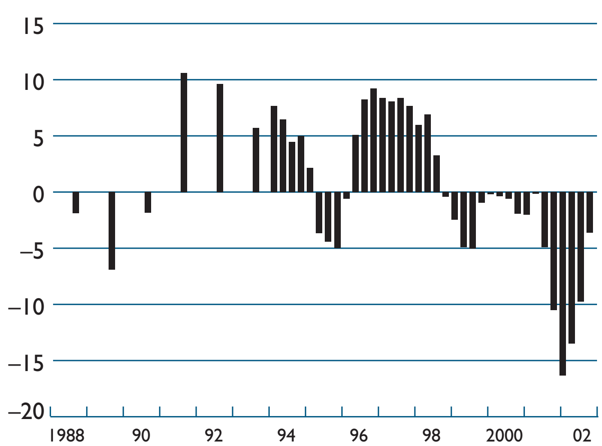
[4]The Convertibility Law was approved by Congress on March 27, 1991, establishing full convertibility of the austral at A10,000 per U.S. dollar (or the new peso created in January 1992 at Arg$1 per U.S. dollar), requiring the central bank in principle to back fully the monetary base with foreign exchange 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.

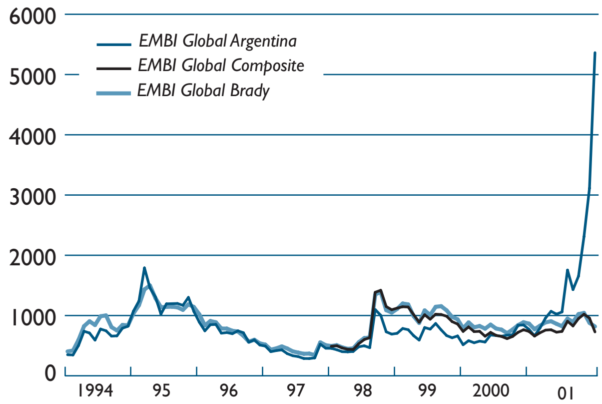
Argentina's problems intensified in 2000, when growing solvency concerns over the cumulative increase in public debt were exacerbated by the continued appreciation of the U.S. dollar and a further drying up of capital flows to emerging market economies. These developments would normally require a smaller 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 *Alianza* 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.