

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 Govern-

¹Board 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.

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

ment 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

³The 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.

⁴Informal 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.

⁵The 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.

¹Based on 1996 trade weights.

²Actual through September 2001.

³Including 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.

⁴World 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

⁶Official 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.

⁷Programmed 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.

⁸Access 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.

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

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-

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.

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

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

involved 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

¹⁰Based 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.

¹¹In 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.

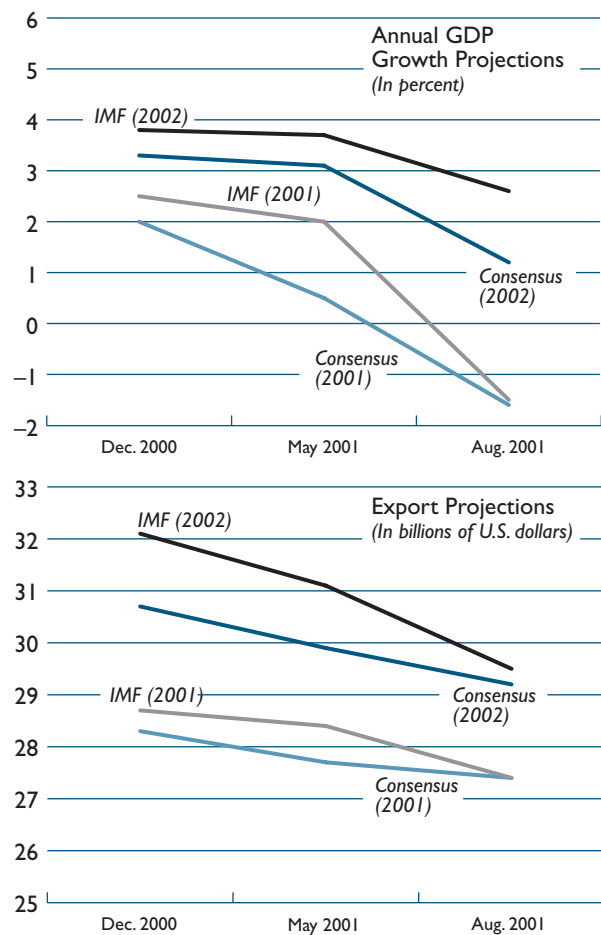
¹²Sensitivity analysis in the staff report examined both public debt sustainability and external sector dynamics, but each sce-

- 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 health, was lacking.¹³

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.

¹³This 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."

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.

¹⁴These 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 Ar-

¹⁵In 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.

gentina 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

¹⁶Following 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.

¹⁷The 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.

Program design and strategy

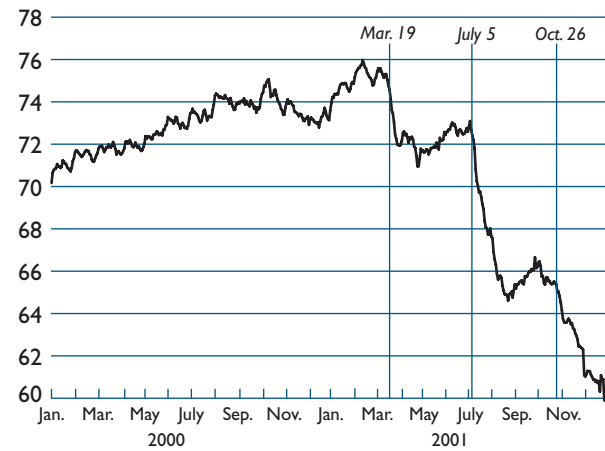
The economic program needed to be revised to compensate for the fiscal slippages recorded in the first quarter (Figure 3.3), and to find additional or alternative policies to rekindle growth, as the expected pickup had failed to materialize. The revised program had three pillars: (i) putting fiscal adjustment 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-

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

¹⁹The 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.

**Figure 3.2. Bank Deposits,
January 3, 2000–December 31, 2001**

(In billions of pesos)



Source: Bloomberg.

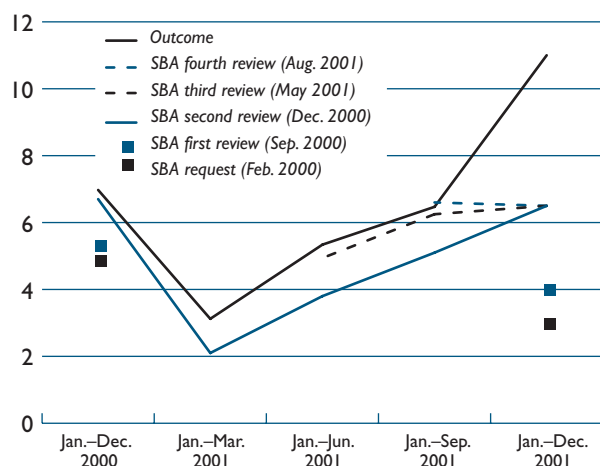
based, “mega-swap” of government bonds to reduce the near-term financing needs of the federal government, though very little information was available on its nature, its cost, and its impact on the debt dynamics. The main assumptions were that GDP growth would gradually build up to 5 percent in the last 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 non-financial private sector, the banking system and the public sector, with a generalized disruption and dislocation of the economy.”

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.

¹A 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

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

²¹Management 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 in-

crease, 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-

²²An 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

²⁴This 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.

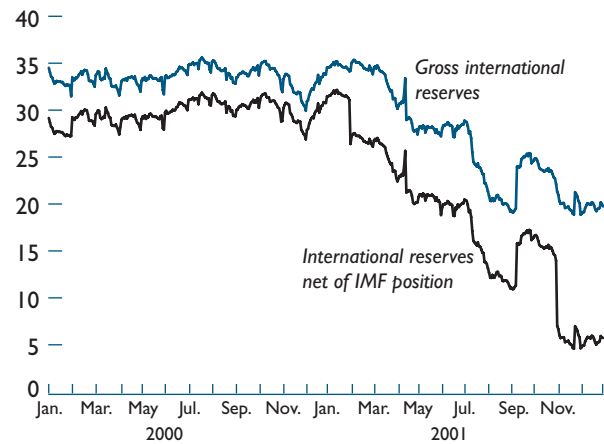
In late July, facing the prospect of a banking crisis if deposit runs could not be stopped, the authorities requested the IMF for the rapid disbursement of a large amount of support. In response, the IMF initially announced that it would consider accelerating disbursements under the existing arrangement, 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 Direc-

²⁵A 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.

Figure 3.4. International Reserves, January 3, 2000–December 31, 2001

(In billions of U.S. dollars)



Sources: Bloomberg; and IMF database.

tors returned from the summer recess on August 20, they were only presented with three:

- 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-

²⁶It 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.

²⁷As 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

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

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

³⁰An 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.”

³¹The 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 au-

³²The 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.”

³³Interestingly, 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.

³⁴The 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.

thorities 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.

³⁵The 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.

³⁶Obviously, 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-

³⁷Specifically, 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."

³⁸Further 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

³⁹A 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.”

⁴⁰This 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.

⁴¹As expressed by FAD at the time.

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

⁴³One 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.”

⁴⁴New 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

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-

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

incentives⁴⁷ 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

⁴⁵The 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.

⁴⁶In 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.

⁴⁷By 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.

⁴⁸The 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

⁴⁹FAD 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

⁵⁰According 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.

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

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 manage-

ment. 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

⁵¹While 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.

⁵²The 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 authorities⁵⁴

⁵³It 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.

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

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

⁵⁵In 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).

⁵⁶There 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

⁵⁷TRE 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.

⁵⁸Such 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

⁵⁹At 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.”

⁶⁰Legally, 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.

⁶¹An “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

⁶²For 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).

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.