

CHAPTER 4

Lessons from the Argentine Crisis

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

Major Findings

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

Overview of the crisis

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

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

decline in Argentina's equilibrium real exchange rate.

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

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

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

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

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

The objective of the strategy followed in 2001 was to minimize the costs of the crisis, not only to the Argentine economy, but also to the international financial system and the IMF. Contagion from Argentina was indeed limited, but it is impossible to state with any certainty whether the lack of contagion was a direct outcome of the way in which the Argentine situation was handled by the IMF. It seems plausible, however, that the protracted nature of the Argentine crisis—and the fact that it was in the end widely anticipated by market participants—was the major factor explaining the lack of wider contagion. The costs to the IMF, however, were sizable. Its financial support inevitably linked the IMF in the view of the public with the unorthodox policies followed by the authorities; its repeated willingness to support such policies and to stretch the use of discretion beyond established access limits gave rise to a perception that it lacked evenhandedness in dealing with member countries.² The concentration

of the IMF’s own credit risk also increased, although this was to some extent unavoidable for a crisis lender such as the IMF. Last but not least, any catalytic role that IMF financing might have had in the past has been put into question, as large-scale IMF support can no longer be seen as signaling policy sustainability.

Surveillance and program design in the precrisis period

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

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

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

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

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

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

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

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

- The IMF's culture discouraged questioning a member country's choice of exchange rate regime, despite the fact that, from the late 1990s, guidance to staff increasingly stressed the importance of providing candid advice to

member countries on exchange rate policy in the context of bilateral surveillance.³

- The IMF lacked a forward-looking concept of exchange rate sustainability and failed to use the best analytical tools. At most, staff looked at standard measures of the real exchange rate based on past price developments, and came to the conclusion that the real exchange rate was at most moderately overvalued by the end of the 1990s. But a deeper and more systematic analysis of the conditions facing Argentina would have led to the conclusion that, in 2000, Argentina's fixed exchange rate could not be sustained for long.⁴

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

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

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

Crisis management

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

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

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

deference to the authorities' determination to succeed; and fear of contagion and concern that the IMF might be seen to cause the demise of a member in distress.

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

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

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

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

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

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

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

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

The IMF was thus faced with choosing between various highly unpalatable—and uncertain—alternatives. Nevertheless, greater contingency planning (with insistence on the authorities' cooperation as a quid pro quo for IMF support for their preferred

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

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

Lessons for the IMF

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

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

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

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

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

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

With these caveats in mind, such a Plan B may well have shared some features of the approach taken in Pakistan, Uruguay, or Ukraine, where the face value of the debt was maintained, maturities stretched, and the interest rate on the new debt capped at below-market interest rates. Even if Argentina’s problems warranted a sharper debt reduction, early action would have likely entailed a smaller haircut than required when a total economic and financial meltdown had occurred. Partic-

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

ularly interesting as a model for Argentina is the approach taken in 2002 in Uruguay, where the IMF provided exceptional support (694 percent of quota) for the government’s efforts to achieve genuine debt relief following a move to a float. In the event, the debt restructuring implemented in early 2003 achieved a 20 percent reduction in the NPV of government debt, with Uruguay remaining current on its debt payments throughout the negotiations.² The debt restructuring was coordinated but voluntary, and took place against the background of a comprehensive, coherent program of economic reforms that was backed by the IMF. However, creditors’ willingness to adopt this approach in Uruguay was itself partly a result of developments in Argentina.

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

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

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

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

Box 4.1 (concluded)

needed to be attempted. In hindsight, an ideal time would have been when there were still ample international reserves to smooth the overshoot of the exchange rate, the balance sheets of banks and pension funds had not yet been weakened by forced purchases of government bonds, and sufficiently large resources were still available from the IMF to shore up both reserves and the banking system, thereby providing confidence in the system and limiting the extent of capital flight. These considerations suggest that the marked—though short-lived—improvement in market

conditions that followed the approval of the first augmentation, in January 2001, provided the best window of opportunity. Another opportunity would have been immediately after the appointment of Mr. Cavallo as Minister of Economy, capitalizing on his international credibility and strong domestic political leadership. Even if that window was missed, such a strategy might have remained viable until late in the year and led to a less traumatic outcome than actually happened—although the costs would still have been very high.

Surveillance and program design

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

surveillance exercises. Discussing exchange rate policy when a fixed peg is involved is inherently sensitive and can potentially alarm the markets. It is precisely for this reason that discussion should be made a routine exercise, something the markets expect to occur as a matter of procedure.

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

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

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

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

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

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

Crisis management

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

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

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

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

Box 4.2. Experience with Catalytic Finance

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

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

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

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

Brazil, respectively, suggests that this lesson has already been learned.

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

Decision-making process

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

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

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

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

Recommendations

Since the Argentine crisis, a number of initiatives have been taken by the IMF to address some of the issues raised above; some changes in procedures and policies were even made before the staff began a systematic effort to draw lessons from this crisis (see PDR, 2003). These changes include: (i) a procedure to systematize and refine debt sustainability exercises as a core tool of analysis; (ii) a procedure to undertake periodic, comprehensive ex post assessments of strategies and policies toward prolonged users of IMF resources; and (iii) a new framework

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

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

for decisions in exceptional access cases, involving clear criteria to assess need and sustainability,¹³ assessment of financial and liquidity risks to the IMF, capacity to repay, use of alternative metrics to determine access, early and more extensive involvement of the Executive Board, and ex post evaluation by staff. While these initiatives, if fully implemented,¹⁴ could go a long way toward ensuring that the mistakes of the Argentine experience will not be repeated, additional steps are necessary to further strengthen these efforts. We present below six sets of recommendations for this purpose, covering crisis management, surveillance, program relationship, and the decision-making process.

Crisis management

Recommendation 1. The IMF should have a contingency strategy from the outset of a crisis, including in particular “stop-loss rules”—a set of criteria to determine if the initial strategy is working and to signal whether a change in approach is needed.

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

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

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

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

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

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

- As mandated by the established guidelines, the IMF should firmly refuse to lend in support of a policy framework that has a high probability of being unsustainable or a low probability of being implemented. Equally important, at such times, the IMF should also take the lead in helping the member country in its transition to a new policy regime, including by offering advice on the transition framework and by providing financing to minimize disruptions and output loss.
- In this context, high priority should be given to defining the role of the IMF when a country seeking exceptional access has a solvency rather than a liquidity problem, especially with respect to its public sector debt. As long as there are uncertainties regarding the role that the IMF should play in the process, it will remain impractical to implement the principles of the Prague framework, which have recently been reaffirmed in the new framework on exceptional access. Progress made in incorporating collective action clauses in new issues of sovereign debt and in developing a code of conduct for sovereign debtors and their creditors is a welcome development, but further efforts are needed to clarify the role that the IMF is expected to play. There may be a broad spectrum of options for the role of the IMF to be assigned by the international community, but the solution must be based on the recognition that, in the Argentine experience, the initial lack of a clear mandate for the IMF once it became clear that a pure catalytic role was unlikely to be sufficient led to an unduly protracted delay before a cooperative solution could be found.

Surveillance

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

- When a country maintains a fixed exchange rate, the IMF should refine tools for assessing the equilibrium real exchange rate that are more forward-looking and rely on a variety of criteria, including market indicators, and use such tools for conducting a systematic analysis of the sustainability of the particular exchange rate, given the country's macroeconomic policy and structural constraints.¹⁵ On the basis of these analyses, the IMF should also systematically engage in a substantive policy dialogue with the authorities on the implications of the regime for other policies as well as on appropriate exit strategies. Such a dialogue should be a routine exercise in the context of Article IV consultations. The Executive Board must back such discussions in the face of inevitable political counterpressure.
- Surveillance should examine debt profiles from the perspective of "debt intolerance," recognizing that the same debt stock relative to GDP may pose a serious problem in one case but not in another, depending on the characteristics of the country's economy and the debt. In line with this emphasis on the debt stock, the IMF should in its program design aim to calibrate the fiscal deficit to achieve appropriate reductions in the debt stock rather than merely the reduction or elimination of year-to-year fiscal deficits. Since the fiscal targets emerging from this exercise must reflect the compulsions of countercyclical policy, some of the focus of fiscal conditionality must be on medium-term improvements. An important implication is that adjustments of fiscal targets should be symmetric—a relaxation of targets in years of unexpectedly low growth or recession should be balanced by a willingness to strengthen targets in years when growth exceeds expectations.
- In all aspects of surveillance, including exchange rate and fiscal policies, the IMF should not only examine near-term vulnerabilities but also take a longer-term perspective on vulnerabilities that could surface over the medium term. A horizon of, say, three to five years is in practice better suited for taking remedial action.

¹⁵Steps in this direction are already being taken.

Program relationship

Recommendation 4. The IMF should refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or structural reform. The markets may well do a better job of disciplining policy than a weak program that is being treated as precautionary. In order to provide an effective signal on whether or not there is adequate political commitment to and domestic ownership of the policy adjustment or structural reform judged to be critical to longer-term sustainability, conditionality in macroeconomic and structural areas that are deemed critical to the achievement of program objectives should be binding, both in design and in implementation. The rationale and analysis underlying any such conditionality should also be made public.

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

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

The decision-making process

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

and the Board on all topics, including the most sensitive ones. Such procedures may include:

- (a) Members of the Executive Board could be more active in their oversight function, including by exercising their right to call a Board meeting or to request the addition of any topic that concerns them to the Board agenda, when they consider that their concern has not been adequately addressed. Recognizing that decisions on exceptional access involve difficult judgments on a variety of topics, upon which reasonable people may disagree, the Board could formalize the right of Directors to request from management ahead of Board discussion additional staff analysis on issues they consider central to the success of the recommended strategy. This would represent an improvement over the current practice whereby some Directors seek additional information or analyses through informal exchanges with senior staff, which are typically not shared with the entire Board.
- (b) Critical issues arise from time to time that are deemed, by management or the Director representing the country concerned, to be too sensitive to be discussed in a full Board meeting. In such cases, the Board effectively yields decision-making power to management or informal subgroups of larger shareholders, weakening its oversight role and accountability. To remedy this problem, the Board and management should work out a procedure to (i) reconcile the need for confidentiality with the need for Board decisions to be based on full and candid information (for example, along the lines of current policy on side-letters) and (ii) ensure that management and staff exercise due diligence to ensure prudent crisis management even when practical considerations require that not all information be disclosed to the Board. Although recent experience with early Board involvement under the new framework for exceptional access suggests that progress has been made in this area, additional steps may be useful. While it is beyond the scope of this evaluation to recommend a specific blueprint, possible arrangements that could be considered include:
 - Establish guidelines whereby the Board could explicitly authorize management to withhold certain issues from discussion in a full Board meeting, with a presumption that, once the sensitivity is no longer present, management's decision is ex post subjected to Board scrutiny.

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

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

mation is being considered and due diligence procedures are being followed by management and staff.

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

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