

Review Essay:

The IMF and the Argentine Meltdown
What Went Wrong and the Lessons Learnt

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When Carlos Saul Menem was elected Argentina's president in May 1989, the economy was already under the punishing throes of hyperinflation. To salvage investor confidence and stabilise the economy, the government resorted to a desperate measure. In March 1991 the Congress passed the "convertibility law" establishing the convertibility of the austral (the Argentine currency since 1985) at a rate of 10,000 australes per U.S. dollar. In January 1992, the peso replaced the austral (1 peso for 10,000 australes). Under this arrangement (a form of a currency board system), outflows of foreign currency reserves had to be matched by reductions in the domestic monetary base. The domestic currency could be issued only in exchange for a specified foreign currency at a fixed rate. The convertibility plan allowed the use of either U.S. dollars or Argentine pesos in any transactions except wage and tax payments. Most importantly, the peso/dollar exchange rate was pegged at one to one with full convertibility between the two currencies. This meant that the public could go to the Argentine central bank and exchange a peso for a dollar, or vice-versa, at any time.

To give credibility to its commitment, the government sharply curtailed the discretionary lending powers of the central bank and stipulated that each peso in circulation had to be backed by the dollar (or similar hard currency) at the central bank. Moreover, the peso supply could not expand without a corresponding increase in the supply of dollars, and reserves consisting of gold and foreign currency or deposits and bonds payable in gold and foreign currency had to be maintained at a level no less than 100 per cent of the monetary base. Domestic money creation was also strictly

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limited as the currency board explicitly forbade monetising government deficits, that is, printing money to pay the bills. Indeed, the convertibility plan effectively tied the hands of domestic policymakers as the currency board shifted the burden of responsibility for monetary policy onto the external sector. Finally, cognisant of the fact that the currency board could not be sustained in the long run without sound fiscal discipline, the government introduced a set of sweeping measures designed to promote market-based structural reforms. Cumulatively, these measures altered the monetary system, improved fiscal and tax policies, deregulated the banking industry, liberalised trade, and reformed the public sector, including the privatisation of the country's debt-ridden state-owned companies in sectors ranging from telephone, airline, railroad, shipping and petrochemicals.

Surpassing all expectations, Argentina's far-reaching reforms produced an unprecedented economic recovery, ushering in a new era of prosperity. From 1991 to 1994, the Argentine economy enjoyed its longest expansion in the entire postwar period. The size of the economy expanded rapidly from an estimated US\$141 billion in 1990 to US\$298 billion in 1998. Inflation, which had been running at over a 1000 per cent annual rate in 1990, fell to less than 5 per cent by the end of 1994. In fact, consumer price inflation was negative by early 1999, while the wholesale prices rose by a mere 1.2 per cent. Price stability provided the framework for strong economic recovery, and between 1991-96, growth averaged almost 9 per cent annually, one of the highest in the world. Equally impressive, the federal government's fiscal deficit receded from an average of about 6-8 per cent of GDP for most of the 1980s to around 2 per cent by the mid-1990s. With such an enviable record, Argentina soon became the poster-child of development -- a model for other emerging economies to emulate.

The credibility of Argentina's currency board was greatly enhanced by its handling of the Mexican peso crisis of 1994-95. In the early days of the crisis nervous investors pulled money out of Argentine banks (deposits fell by some 18 per cent), besides exchanging pesos for dollars. In 1995 alone, Argentina suffered a capital outflow of some US\$6 billion. All this caused a contraction in the country's money supply, resulting in a sharp drop in economic activity. Overall, the economy shrank by 2.8 per cent in 1995. Because the Argentine central bank had no control over monetary policy under the currency board system, it was relatively helpless in counteracting the contractionary monetary policy stemming from investor behaviour. Moreover, because the currency board did not allow the central bank to create pesos and lend them to the banks, it had very little capability to act as a lender of last resort.

Nevertheless, what the government could do, it did quite effectively -- namely, overhauling the banking system, slashing the federal budget and tightening fiscal policy. More importantly, the government's take-charge response prompted the multilateral financial agencies to come forward with generous support. The prompt assistance by the IMF, the World Bank and the Inter-American Development Bank (which altogether lent over US\$5 billion), enabled Argentina to shore up both the banking and the currency board system. The country's ability to maintain its fixed exchange rate vis-a-vis the U.S. dollar boosted domestic and international investor confidence -- thereby enabling it to survive the contagion from the Mexican crisis. Indeed, after a sharp recession in 1995, the Argentine economy resumed rapid growth in late 1995 -- notching an impressive growth rate of 8.4 per cent in 1997.

The Asian and the Russian financial shocks of 1997-98 posed another grave challenge. Yet, once again Argentina weathered the fallout relatively well. This further convinced many that the economic reform measures coupled with the convertibility plan was key to Argentina's remarkable resilience. In fact, so enamoured were the international financial community with Argentina's record that the IMF publicly applauded many of the country's economic policies. Not surprisingly, Argentina became the quintessential emerging market economy -- a model for others to emulate. Not only did President Menem become the most sought-after speaker at gatherings of financial heads, Argentina was now able to float a large issue of medium-term and long-term debt on world credit markets at comparatively modest spreads over US Treasuries.

However, a decade after it began, the Argentine miracle was over. In late December 2001, Argentina defaulted on its US\$155 billion of central and provincial government debt -- the largest sovereign debt default ever. On 6 January 2002, after three changes of government following large-scale street protests, the exchange rate peg was abandoned and the currency allowed to float freely against the dollar. Immediately, the peso was devalued to four pesos per dollar.

What went wrong? Clearly the Argentine tragedy was gradual in the making. Specifically, it was the third systemic financial shock, the Brazilian devaluation in January 1999 that fundamentally tested the feasibility of the currency board. As the devaluation of the Brazilian *real* pushed the bilateral exchange rate of the peso up by nearly 18 per cent in real terms, the adjustment burden in Argentina was sudden and harsh. Unlike Mexico and the Asian economies, Brazil is Argentina's main trading partner and

competitor. Brazil's floating exchange rate made the *real* increasingly competitive against the Argentine peso. With its wages and inputs in dollars, Argentina's exports were simply too expensive to compete with those of Brazil and other developing countries. The appreciation of the dollar in the late 1990s further compounded the problem. As the currency board experienced overvaluation, Argentina's exports became even less competitive on the world market. As these effects spilled over to the real side of the economy, it resulted in an overall slowdown in activity.

To keep the peso-dollar peg intact as the economy became less competitive, the authorities tightened macroeconomic policy and raised interest rates. The high interest rates produced a mushrooming government deficit because of the higher interest on the national debt and lower tax base as the economic downturn took its toll. The end result was a sluggish economy with growing debt and burgeoning trade imbalance and current-account deficit -- which reached nearly 5 per cent of GDP in 2000. Indeed, the trade imbalance made it impossible for Argentina to earn the foreign exchange needed to pay the interest on its foreign debt. Instead, it had to borrow to meet these interest payments -- causing the debt to grow even larger.

The 2000-2001 global economic slowdown sealed the fate of Argentina's monetary and exchange rate arrangements. Industrial production declined by a massive 18 per cent by December 2001 on a year-on-year basis, while GDP had contracted by nearly 5 per cent. In mid-2000 the government raised income taxes in an effort to balance its budget. On 20 November 2001, the government was forced to create the so-called "*corralito*" (i.e. a bank deposit freeze). This measure imposed restrictions on deposit withdrawals, limiting the cash withdrawals from savings and checking accounts to \$1,000 per month, besides levying a tax on financial transactions. But these efforts failed to stop or slow the economic decline. Most troubling was the steady rise in the current account deficit -- which had widened to nearly 7 per cent of GDP by the third-quarter of 2001. Despite significant IMF assistance, Argentina now faced a major crisis of confidence as bank deposits, both peso and dollar denominated became subject to unrelenting attrition. Roughly US\$20 billion in capital fled the country in 2001, while the peso interest rates climbed to between 40 per cent to 60 per cent, further weakening the government's budget position. Against these negative trends, domestic lending contracted, as did output and employment. At the end of 2001, Argentina moved to a dual exchange rate system by adopting a preferential exchange rate peg for exports. This move eliminated the characteristic of full convertibility. However, it failed to reassure the markets. The government then froze bank deposits in

December 2001 in a last-ditch effort to save the financial system from collapse -- but it was too little too late. After all, Argentina's fixed exchange rate system was based on full capital account convertibility. This not only allowed domestic residents to convert pesos to dollars at a fixed exchange rate on one peso per dollar, but also allowed an unlimited export of those dollars -- much of which had already taken place. In the end, unable to control the interest rate differentials between peso-denominated and dollar-denominated debt, Argentina abandoned it in January 2002. On February 3 the government announced it would turn all dollar debts into pesos at a rate of one-to-one. This change would help debtors pay back their loans since it will reduce the value of their debt substantially because the floating value of the local peso is at a volatile actual market rate of around two pesos per dollar. However, both the creditors and the banks will suffer losses because of the so-called "*pesofication*" of debt. Furthermore, this economic plan also turns all dollar deposits into local pesos at a rate of 1.4 to the dollar.

The Argentine meltdown raises some important broader questions. First, what role did the IMF play prior to the crisis? In his appropriately titled monograph, *Argentina and the Fund: From Triumph to Tragedy* former IMF chief economist Michael Mussa provides a balanced and well-reasoned analysis. Mussa's study traces the evolution of Argentina from being one of the Fund's greatest success stories through most of the 1990s to one of its most tragic failures. He emphasises that Argentina, during the past decade, is a particularly important case for evaluating the role and performance of the IMF because unlike most other countries that have recently received large amounts of IMF financing, Argentina did not request support only as a crisis was under way or practically unavoidable, but rather was under the scrutiny of IMF-supported programmes throughout the period¹. Although the key decisions in the vital areas of fiscal, monetary, and exchange rate policy were undoubtedly those of the Argentine authorities and generally enjoyed broad popular support, the IMF supported and praised these policies and thus must bear significant responsibility for their final tragic failure.

¹ Argentina has received extensive assistance from the IMF over the past years. For example, in March 2000, the IMF agreed to a 3-year, \$7.2 billion arrangement with Argentina. Moreover, in January 2001, the IMF augmented its earlier agreement by pledging another \$7 billion for it as part of a larger \$40 billion assistance package which involves the Inter-American Development Bank, the World Bank, Spain, and private lenders.

Specifically, to Mussa, the persistent inability of the Argentine authorities at all levels to run a responsible fiscal policy -- even when the economy was performing well -- was the primary avoidable cause of the country's catastrophic financial collapse. He adds that this failure was clearly avoidable, especially when Argentina's economy was performing well. In particular, from 1993 to 1998, Argentina's GDP advanced 26 per cent and the government enjoyed substantial fiscal benefits from privatisation and the Brady bond restructuring. However, during the same period the ratio of government debt to GDP rose from 29 to 41 per cent -- demonstrating an addiction to fiscal laxity. This would prove fatal in far less advantageous circumstances that prevailed after 1998. When times were good, however, the IMF failed to press Argentina to run a sustainable fiscal policy and thus it bears heavy responsibility for the critical failure in this vital area. Moreover, while the IMF accepted the convertibility plan as a basic policy choice of the Argentine authorities so long as it remained viable, it erred in the summer of 2001 by extending further massive support for unsustainable policies. Put bluntly, although the decision to persist with the convertibility plan, especially as it came under increasing pressure during the period 1999-2001 were clearly the choice of the Argentine authorities, the IMF, nevertheless, supported these decisions and thus must share part of the blame for the Argentine tragedy.

Mussa notes that for more than a year after the Brazilian crisis, Argentina remained the darling of emerging-market finance and was able to continue floating large bond issues on private international credit markets. By late 2000, however, global markets came to question the sustainability of Argentina's finances and a potentially devastating crisis loomed. The IMF responded with a large international support package, conditioned on Argentina's commitment to rein in its fiscal deficit. Mussa concludes that this effort was reasonable to give Argentina a last chance to avoid disaster; despite clear risks that the effort might not succeed -- albeit, those risks were not yet overwhelming. However, during the first eight months of 2001, Argentina's efforts in the fiscal area continued to fall short. Global financial markets became progressively more disillusioned. Domestic runs on Argentine banks depleted reserves. There was no longer a realistic hope of avoiding a sovereign debt restructuring and probably a revocation or substantial modification of the Convertibility Plan. At this point, Mussa concludes, the IMF made another important mistake by disbursing another large chunk of support for an effort that was doomed to fail and by not insisting that the Argentine authorities needed to consider an alternative policy strategy before events compelled an even more catastrophic outcome. That outcome was finally forced in early December 2001 by runs on Argentine banks and the government's decision to restrict bank withdrawals.

Nevertheless, the situation continued to deteriorate.² Despite the election by the Argentine Congress of a new President, Eduardo Duhalde, to fill out his predecessor's term, the Argentine government failed to put together a credible policy programme to stabilise the economy and financial system and begin the process of recovery. Rather, Duhalde's prescriptions which included the end of the currency board and the implementation of a dual exchange rate in which the peso was floated for financial transactions and fixed the ratio at 1.4 pesos to the dollar for foreign trade and certain other transactions was clearly not enough. On top of that he also continued the freeze of bank deposits in dollars over certain thresholds.

In this context, the IMF correctly withheld further support. Mussa concludes by listing the requirements for a credible new Argentine economic programme: reasonable economic assumptions, fiscal discipline that recognises both Argentina's dire situation and the limits on available financing, a monetary policy that avoids hyperinflation, responsible efforts to resurrect the banking system, and fair treatment of external creditors and other claimants on defaulted contracts. He also suggests an appropriate scale of potential IMF support: a roll-over of payments already owed to the IMF plus, under stronger conditionality if it can be negotiated, additional money up to an annual limit of Argentina's IMF quota.

Mussa notes that it is essential for the IMF itself to learn the right lessons from the failures in Argentina. He argues that better mechanisms of responsibility and accountability are needed in the Fund. Internal discussion and dissent, including to countervail the tendency of many staff and management to give the benefit of the doubt to a country's authorities, needs to be encouraged, with more active involvement of the IMF's Executive Board. Critical evaluations of IMF programmes need to be seriously undertaken by the newly created independent evaluation office, with particular emphasis on programmes with high levels of Fund support. Finally, Mussa notes that the case of Argentina has general implications for the use and usefulness of large IMF support packages. Argentina, in addition to Russia and several smaller cases, shows that the frequently raised concern of "moral hazard" arising from such support has surely been over emphasised. The Argentine case indeed has provided a clear message that private creditors cannot rely on protection from the official sector when it engages in

² On November 30, 2001, President de la Rúa imposed a \$ 1,000 per month limitation on personal bank withdrawals. As a result of this restriction and other austerity changes in the Argentine government, violent protest broke out and President de la Rúa was forced out of office on December 20 of last year. Over the next ten days, there were four different presidents of Argentina, including Mr. Eduardo Duhalde, who is currently in power.

imprudent lending. Rather, private creditors and, more importantly, the international community as a whole need to have an IMF that applies responsible discretion in determining those circumstances in which it is reasonable and desirable—and those circumstances in which it is not reasonable or desirable—for the IMF to commit large-scale support.

More broadly, Mussa notes that if Argentina had decided in 1997 or even in mid-1998 that the convertibility plan had fulfilled its purpose and the time had come to shift to a more flexible regime for exchange rate and monetary policy, it might have been better able to manage the difficulties of 1999-2001. Clearly in a globalised world, a fixed exchange rate regime introduces unnecessary rigidity in the policy-making arena. Globalisation exposes economies to external shocks and these shocks can be more easily absorbed with flexible exchange rates. The Argentine authorities concern regarding inflation was valid, but these concerns need to be balanced against other objectives. There is little justification for maintaining a commitment to low inflation in the face of declining output and rising unemployment.

Second, what does the crisis tell us about the efficacy of currency boards? No doubt, the question of whether and when exactly the currency board could or should have been abandoned remains a matter of debate. One option would have been to do it as soon as the credibility of the monetary strategy had been established – say after three years. Another possibility would have been in 1996-97 when the economy was rebounding after the Mexican crisis. In hindsight, this may have been the last chance for an orderly exit. Suffice it to note, a currency board system can be credible only if the central bank holds sufficient official foreign exchange reserves to at least cover the entire narrow money supply. In this way, financial markets and the public can be assured that every domestic currency bill is backed by an equivalent amount of foreign currency in the official coffers. This was not the case in Argentina. The Argentine case has shown that if countries have open capital accounts, hard pegs based on currency boards are difficult to put in practice. For a fixed exchange rate regime to coexist with an open capital account, product and labour markets need to be highly flexible. Again, this was not the case in Argentina. More broadly, Argentina's failed currency board illustrates that an improper exchange rate peg is doomed to failure no matter how rigorously one imposes conditions to engender credibility. Clearly, exchange rate arrangements are no cure for problems in the area of macroeconomic policy. Despite the relatively strong set of rules governing the conduct of Argentina's currency board, the regime collapsed in relatively quick order when domestic and foreign investors determined that the Argentine government's fiscal policies were unsustainable. The moral of the story is unambiguous: no fixed exchange rate regime, even one as institutionally strong as

Argentina's is completely sound. Perhaps the most important lesson from Argentina's experience is that an exchange rate regime is only as good as its peg.

Third, is dollarisation the cure? Both, long before and following the devaluation, some Argentine policymakers suggested that dollarisation is the answer to Argentina's woes. The argument is that market speculation over a possible devaluation resulted in a loss of credibility and that the replacement of Argentine pesos with U.S. currency as the only official medium of exchange would eliminate Argentina's currency risks, lower interest rates and instill confidence. While they consider the convertibility plan to be the best policy decision of the 1990s, they now argue that it is time to take it further – with dollarisation. Yet, dollarisation and currency boards help establish fiscal credibility, they do not guarantee fiscal health. Argentina benefited from the currency board-like system in the early years, but that success did not lead to consistent fiscal reform and investment. Under dollarisation, Argentina would have experienced the same exchange rate appreciation and therefore the same loss of competitiveness vis-à-vis its primary trading partners who were not tied to the dollar. Thus, Argentina would have probably ended up in a similar unsustainable fiscal situation. Either way, the miracle would have come to a similar abrupt and tragic end.

Finally, what explains why contagion was limited following the Argentine default? There are three basic explanations. First, the default was largely expected. Since the crisis unfolded almost in slow motion, investors had ample opportunity to restructure their portfolios in advance. With the exception of Uruguay, most Latin American banks have maintained only a small exposure to Argentina. The Chilean corporate sector holds large investments in Argentina and has reported substantial valuation losses. But they have not been large enough to have a significant impact on the Chilean stock market or banking sector. Second, better and more timely economic information has fostered increased investor discrimination. This is an important example of how the global effort to reform the architecture of the international financial system is bearing fruit. Third, the search for increased portfolio diversification in an environment of ample global liquidity, low returns in the US and growing concerns about the quality of US corporate bonds after Enron has favoured large and relatively liquid markets such as Mexico and Brazil. Argentina's share in the EMBI-Plus emerging market bond index has fallen from a peak of nearly 30 percent at the end of 1998, to 15 percent at the end of last October, to barely 2 percent now.

Currently, Argentina faces a highly complex set of challenges in the economic and financial sphere. Output and employment are depressed, the normal functioning of the banking system has been disrupted, the Government

is unable to service its debts, and substitute quasi-currencies are circulating throughout the economy. The crisis has given rise to substantial financial losses, many of which have yet to be recognised and attributed. Confidence is at a low ebb, not only in the economic and financial system, but also in social and political structures more generally. Moreover, the present government is of an interim nature, and will hand over to a new administration following elections scheduled for March 2003. Clearly, the rebuilding of the Argentine economy will be long and hard.