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Introduction: Setting the Stage

In the sad economic history of Argentina during the past half-century, the past decade encompassed a remarkable transition. Rising from the ashes of yet another episode of economic chaos and hyperinflation at the end of the 1980s, the surprisingly orthodox policies of the new Peronist president, Carlos Menem, brought a decisive end to decades of monetary instability and launched the Argentine economy into four years of unusually rapid and sustained expansion. Those economic policies, which were largely the brainchild of President Menem's formidable economy minister, Domingo Cavallo, featured a hard peg of the Argentine peso at parity to the US dollar, backed by the Convertibility Plan, which strictly limited domestic money creation under an arrangement similar to a currency board.

Many doubted whether the new policy regime would survive, especially as tensions rose during the tequila crisis initiated by the Mexican devaluation of December 1994. But it did survive; and after a sharp recession in 1995 (and persistently high unemployment thereafter), the Argentine economy resumed rapid growth from late 1995 until the spillover effects of the Brazilian crisis hit Argentina in late 1998. Indeed, with most of the miracle economies of emerging Asia collapsing into crises from mid-1997 to early 1998, Argentina became the darling of emerging-market finance—able to float large issues of medium-term and long-term debt on world credit markets at comparatively modest spreads over US Treasuries. And in the official international financial community, especially the International Monetary Fund, many of Argentina's economic policies were widely applauded and suggested as a model that other emerging-market countries should emulate—international approval that was dramatized by President Menem's triumphant address to the IMF-World Bank Annual Meetings on 4 October 1998.

Barely three years later, Argentina's decade-long experiment with hard money and orthodox policies has ended in tragedy—the depths of which are not yet fully known. The economy is well into its fourth year of recession and rapidly spiraling downward. Most of the banking system has effectively been closed since the beginning of December 2001, and there is no indication of when it may resume something approaching normal operations. The exchange rate peg is gone, and the peso is trading at substantially depreciated exchange rates against the dollar. Economic and financial chaos—banished from Argentina since the hyperinflation of 1990—have returned, and there is a real threat that hyperinflation itself may soon return unless the Argentine authorities can rapidly reestablish and maintain credible monetary and fiscal discipline. With formal default on its sovereign external debt, Argentina has been transformed within barely two years from the darling of emerging-market finance to the world's leading deadbeat.

Focus on the Role of the Fund

These developments, of course, mainly concern the Argentine people. It is they who feel the great pain of the current tragedy. It is their government that designed and pursued the policies that led both to this tragedy and to the substantial successes that were achieved earlier. And it is their government, with their support, that has the responsibility to find a way out of the present morass. However, the international community, both official and private, played a significant role in the economic evolution of Argentina during the past decade; and it should seek to play a constructive role going forward. Indeed, the purpose of this policy analysis is primarily to examine the role of the International Monetary Fund, and of the international community more broadly, in Argentina's transition from triumph to tragedy during the past decade.

The Argentine case is important for understanding the Fund because Argentina is an important country and dealing with its present difficulties poses a substantial challenge for the international community. Moreover, the way critical issues are dealt with in the Argentine case, notably the resolution of Argentina's sovereign default, will undoubtedly set important precedents that will influence the future functioning of the international financial system.

More than this, however, the Argentine case is particularly revealing because the Fund was deeply involved with Argentina for many years before the emergence of the present crisis. In this important respect, Argentina is different from most other cases where the Fund has provided exceptionally large financial support. Virtually continuously throughout the 1990s, Argentina operated under the auspices and close scrutiny of a Fund-supported program. In contrast, in other cases where the Fund provided exceptionally large support (Mexico in 1995; Indonesia, South Korea, and Thailand in the Asian crisis; Brazil in the crisis of late 1998 and early 1999), a Fund-supported program was started only after the crisis was already under way.

Thus, any failures of the Fund in the pre-crisis period were those of its relatively low-intensity surveillance activities. For Argentina, the failures of the Fund are clearly associated with the core of the Fund's most intense involvement with a member: when it is providing financial assistance and when the policies and performance of the member are subject to the intense scrutiny of Fund conditionality. Leaving aside Turkey, where the outcome is not yet clear, the only other case of exceptionally large Fund financing to a member already operating under a Fund-supported program was Russia in the summer of 1998. But Russia was a very special case. The Fund (and the rest of the international financial community) faced the new challenge of assisting a country involved in the transition from a socialist to a market economy; and there were intense political concerns in the Russian case that spread well beyond the economic and financial sphere.

For Argentina, these additional concerns were by no means as intense. Moreover, in Russia and in the countries caught up in the Asian crisis, the key policy issues involved deep problems of structural reform (including problems of financial sector) that passed beyond the Fund's established areas of competence. In contrast, the economic issues that Argentina needed to confront were primarily in the areas of fiscal, monetary, and exchange rate policy—the traditional bread and butter of Fund policy concerns. Thus, to the extent that the Fund got it wrong, or failed to get it right, in Argentina, this is likely to be revealing of particularly deep-seated deficiencies.

Necessarily, the emphasis here must be on issues where the Fund got it wrong in Argentina. This does not imply that the Fund got it completely wrong or that the Fund, rather than the Argentine authorities, was primarily responsible for the ultimate outcome. However, the end result in Argentina has clearly been a disaster of considerable magnitude. This disaster was certainly not intended or, until relatively recently, broadly anticipated—by the Argentine authorities, the Fund, or anyone else.

No reasonable person, however, should believe that substantially better outcomes were not achievable under realistic alternative economic policies if they had been implemented sufficiently early and appropriately vigorously. And, in view of the Fund's deep and continuing involvement with Argentina's economic policies, its financial support for those policies, and the confidence in and praise for those policies that the Fund so often expressed, it follows that the Fund must bear responsibility for the mistakes that it made in this important case; and it must be prepared to recognize and learn from these mistakes.

I shall argue that the Fund did make at least two important mistakes in Argentina: (1) in failing to press the Argentine authorities much harder to have a more responsible fiscal policy, especially during the high growth years of the early through mid 1990s; and (2) in extending substantial additional financial support to Argentina during the summer of 2001, after it had become abundantly clear that the Argentine government's efforts to avoid default and maintain the exchange rate peg had no reasonable chance of success.

I shall also discuss three other important issues where it might reasonably be argued that the Fund got it wrong but for which, in view of the Fund's particular mandate and responsibilities vis-à-vis its members, it did take the right position: (1) the initial skepticism at the Fund about the desirability and viability of the exchange rate peg before the tequila crisis; (2) the Fund's subsequent support for the Argentine decision to maintain the peg; and (3) the decision by the Fund in December 2000 (formally approved by the Executive Board in early 2001) to organize a large international financial support package to assist Argentina at a time when a number of competent observers were concerned that such a large support package was not appropriate.

To develop the basis for the analysis of these issues, it is essential to review key aspects of the economic evolution of Argentina during the past decade. In particular, because sovereign default was clearly a critical factor in provoking the present catastrophe, it is important to understand how the Argentine government proceeded from a situation of apparent solvency—reflected in its ability to float large volumes of debt in international financial markets—to the point where it could no longer service its obligations. And, given the Fund's traditional emphasis on fiscal probity, it is important to discuss what the Fund was saying and doing as Argentina's fiscal situation deteriorated.

It is also clear that the collapse of Argentina's Convertibility Plan in late 2001 played a central role in the present crisis. Accordingly, it is critical to examine both how the Convertibility Plan contributed to the initial success of Argentina's stabilization and reform efforts and why the plan ultimately collapsed in tragedy. Moreover, as with Argentina's fiscal policy, it is important to discuss what the Fund was saying and doing about Argentina's monetary and exchange rate policy, both as the crisis loomed and at an earlier stage when a more orderly shift away from the Convertibility Plan might have been undertaken.

During 2000 and 2001, as the threat of a catastrophic crisis clearly deepened, the Argentine government undertook increasingly urgent and desperate measures to try to head off that crisis. The Fund supported these efforts with exceptionally large financial packages, despite deep concerns of many in the international community about the usefulness and appropriateness of such packages. These efforts clearly failed catastrophically—giving rise to the question of whether they were wise in the first place, or whether an earlier decision to accept the inevitable might have led to a less disastrous outcome.

Looking to the future rather than the past, it also seems relevant to examine what Argentina needs to emerge as rapidly and successfully as possible from the present crisis, and what the Fund and the international community can and should do to assist Argentina in this endeavor. In addition, because experience is the most effective teacher and the lessons from failure may be even more valuable than those from success, it is appropriate to reflect on the lessons that Argentina may teach about the Fund and how it might better fulfill its responsibilities in the international monetary and financial system. Before turning to these issues, however, it is essential to state one important qualification about what is said in this book.

An Essential Qualification

A good deal has already been written and said in the media about the crisis in Argentina and the role played by the Fund; and much more will be said. Most commentators, both journalists and economists, have been careful so far to emphasize one critical point about the policies that ultimately led to the crisis: they were the policies desired and implemented by the Argentine government. In general, the Fund supported these policies, both with its statements and with its financing, but the Fund did not press the Argentine government to adopt policies that it did not willingly choose to implement.

This is especially true in what proved to be the two most important areas of Argentine economic policy: monetary and exchange rate policy, and fiscal policy. In fact, the initial decision to adopt the Convertibility Plan—which rigidly linked the peso at parity to the US dollar and tightly constrained monetary policy to support the exchange rate peg—was made by the Argentine government against the advice of the Fund. Many of the Fund's staff (myself included) remained highly skeptical about this policy through the mid-1990s. After the arrangement survived the tequila crisis (thanks to particularly effective policy management by the Argentine authorities and with moderate financial support from the Fund), the attitude in the Fund generally shifted to support for the arrangement.

Subsequent decisions 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. These decisions were supported by the Fund. But there should be no doubt that if the Argentines had decided to move to an alternative, more flexible exchange rate and monetary policy regime that maintained reasonable monetary discipline, this would also have been acceptable to the Fund. Indeed, at least some in the Fund (although probably not a majority at the time) would have welcomed serious consideration of such a move by the Argentine authorities.

In the area of fiscal policy, the persistent running of significant fiscal deficits and the consequent increases in the stock of government debt were clearly the result of decisions by the Argentine authorities. In accord with its usual preferences, the Fund would have generally favored smaller deficits and less debt buildup. In the policies adopted to meet the challenge of the tequila crisis, the Fund did (as usual) press for a tighter fiscal stance to reassure Argentina's somewhat nervous creditors. The Fund was also understanding (to an unusual extent by previous standards) when the fiscal position deteriorated more than anticipated during 1995 because the economy was weaker than had been expected.

During the next three years, the Argentine economy generally recovered more rapidly than was envisioned in the Fund-supported programs. This should easily have allowed the Argentine authorities to achieve smaller fiscal deficits than were allowed for in these programs. Instead, the Argentine authorities chose to run slightly larger deficits (in nominal terms) than permitted by the program targets. In addition, there was a buildup of government debt (including provincial debt) that, for a variety of reasons, was not included in the deficit targets. In this period, as a result of the actions of the Argentine authorities, the cumulative buildup of government debt was significantly larger than the Fund expected and would have liked to see.

During the period 2000–01, as doubts grew about the ability of Argentina to service its growing debt burden and sustain its exchange rate peg, the new Argentine authorities decided to adopt austerity measures to attempt to reduce the fiscal deficit and thereby reassure creditors. The Fund supported these measures. In fact, the conditionality associated with the large support package of December 2000 insisted on fiscal polices that would significantly reduce the deficit—despite the ongoing recession in Argentina. The Argentine authorities accepted that such measures were essential to meet their objectives of avoiding the devastating consequences of default and/or devaluation.

As the crisis deepened during the course of 2001 and the deficit targets set in the Fund-supported program were missed, the Argentine authorities sought to undertake further austerity measures. The Fund supported these efforts as essential to meet the key objectives set by the Argentine authorities. However, had the Argentine authorities decided at some time during 2000–01 (before the collapse in December 2001) to pursue an alternative course involving debt restructuring and a possible change in the exchange rate regime, the Fund would have supported responsible efforts in this direction.

At the Fund, there has been much recent discussion of the importance of "ownership" of Fund-supported programs—in the sense that the authorities fully accept the necessity and desirability of the policy measures that they have agreed on with the Fund. Sometimes in Fund-supported programs, ownership is a problem, especially when the Fund presses (on behalf of the international community) for policies that raise domestic political difficulties.

Policy ownership was not an issue in Argentina during the past decade. For better or worse, all the key policies were fully owned by the Argentine authorities. Accordingly, if the Fund made important mistakes in Argentina—as I believe it did—they must have been primarily sins of omission: either failures of the Fund to press hard enough and soon enough for policies of the Argentine government that would have been likely to improve the outcome; or failures of the Fund to discourage sufficiently forcefully policies that exacerbated the tragedy.