3

Down the Road to Catastrophe

It is difficult to know at what point an economic catastrophe for Argentina became inevitable. The collapse of Brazil's exchange-rate-based stabilization effort, the Real Plan, in early 1999 was an important negative shock for Argentina. This was well understood in global financial markets, and interest rate spreads on Argentine bonds rose along with (although not as much as) Brazilian spreads as doubts about the sustainability of the Real Plan deepened in the autumn of 1998 and early 1999. When the collapse came in mid-January 1999 and intense financial turmoil continued in Brazil for another month, the spillover effects effectively shut Argentina out of global financial markets. However, as the situation in Brazil calmed down during the spring of 1999 (with the aid of exceptionally adept management of Brazilian monetary policy by the new central bank governor), Argentina regained access to global credit markets, and usually on relatively attractive terms.

The success of Argentina in floating substantial amounts of sovereign debt in global credit markets during much of 1999 and the first half of 2000 testifies both to the special conditions in those markets and to Argentine authorities' particularly deft management of the public debt. With the advent of the euro (and in anticipation of that event), interest rates for previous high-yield borrowers within the euro area converged downward toward the yields of the lowest-rate borrowers. This left a clientele of investors in the euro area with potential interest in higher-yielding instruments. Argentina was quick to exploit this market opportunity with issues denominated in the new multilateral currency.

The Argentine debt managers were also careful to avoid excessive reliance on short-term debt or on instruments with floating interest rates.

Institute for International Economics | http://www.iie.com

Such borrowing often has somewhat lower costs than financing through medium- and longer-term fixed-rate instruments, but it is much more dangerous for a country like Argentina that may be under sudden pressure to raise short-term rates in the face of pressures on the exchange rate or doubts about fiscal sustainability. Financial markets undoubtedly respected and probably rewarded Argentina's prudent debt management policies.

Argentine debt management also benefited from a good domestic market for Argentine government debt. Confidence in the Convertibility Plan and in the measures to ensure a sound banking system clearly contributed to a massive reflation of domestic credit. Because domestic financial institutions are important holders of sovereign debt, this credit reflation created an important domestic market for government debt. In addition, the reforms adopted by the Argentine government included the creation of funded pension plans. The assets accumulated by these plans were substantial, and a significant fraction of these assets consisted of investments in Argentine government debt. The existence of a substantial, relatively stable domestic market for Argentine government debt was also presumably reassuring to international investors and, accordingly, tended to support their demand for Argentine instruments.

On the policy front, developments during 1999 and the first half of 2000 were less reassuring than those on the financial front. President Menem's quest for a constitutional amendment that would permit him to run for a third consecutive term was clearly not a spur to determined efforts at fiscal consolidation, from the start of his second term in 1995 through much of his final year in office (which ended in December 1999). And after this possibility was finally laid to rest, election-year concerns further depressed the normally low level of interest that most Argentine politicians, at all levels of government, attached to measures of fiscal prudence. Meanwhile, the continuing recession in the Argentine economy (which began in late 1998) was depressing tax revenues and increasing demands for compensatory social spending—thus contributing to an already difficult environment for efforts to rein in the fiscal deficit.

Conditions deteriorated during the second half of 2000 as the recession continued and as turmoil within the administration of President Fernando de la Rua (including the resignation of the vice president) both inhibited decisive action and undermined confidence. Analysts of the Argentine economy—who (with some exceptions) had remained supportive of the longer-run viability of the government's finances through 1999—began to turn pessimistic, and the possibility of a default on Argentina's sovereign debt was openly discussed.

At the International Monetary Fund as well, concerns mounted about the deteriorating situation in Argentina as the recession deepened and the fiscal deficit continued to grow. By October, it appeared that the (not overly ambitious) fiscal deficit target in the Fund-supported program for

Institute for International Economics | http://www.iie.com

the end of 2000 might well be missed. Even if this embarrassment could somehow be avoided (or swept under the rug, as on two earlier occasions), it was clear that the Argentine government would face severe difficulties in meeting its financing requirements for 2001; the possibility of sovereign default loomed.

Because the sovereign debt of Argentina was mainly fixed rate and medium term, it did not face the challenge of rolling over large amounts of short-term debt or the threat that the budgetary effect of an upward spike in interest rates would suddenly make the fiscal situation unsustainable. However, with little prospect of generating substantial primary surpluses that would pay off much of the debt as it matured, the Argentine government did face a large continuing need to refinance its large debt. For each of the five years from 2001 through 2005, projected financing requirements were about $22 billion—under the (optimistic) assumption that the fiscal deficit could be contained to a level that roughly stabilized the ratio of debt to GDP. Domestic sources might reasonably be expected to supply about half of the needed financing: through continuing rollover of a modest amount of short-term domestic-currency debt; and through the rollover of (and some additional investment in) medium- and longer-term dollar-denominated debt by domestic holders, notably banks and pension funds. The remainder of the needed financing would need to come from external sources.

By late 2000, the Argentine government was the largest emerging-market borrower on international credit markets, with outstanding obligations amounting to slightly more than 20 percent of the entire asset class. Shrewd debt management and careful exploitation of all available market opportunities had enabled the Argentine sovereign to float substantial new debt issues on international markets in 1999 and 2000. But the market was becoming saturated. With rising doubts about Argentina's ultimate ability and willingness to service its debts, the government needed to demonstrate its capacity to restrain its appetite for public borrowing to within reasonable limits before international credit markets would willingly take on additional exposure—or even agree to roll over most of their maturing claims.

Options for the Fund and the International Community

For the Fund, the deteriorating situation in Argentina in the autumn of 2000 presented a critical challenge. An important emerging-market country was already in deep economic difficulty and was potentially on the threshold of sovereign default and financial chaos. A star pupil that the Fund had praised and supported as a model of economic stabilization and reform was in danger of turning into a basket case.

Institute for International Economics | http://www.iie.com

By November, Argentina appeared likely to breach the revised fiscal performance criteria for the end of 2000 (which the Fund had already agreed in September to change to accommodate a larger deficit). This could have provided a plausible excuse for the Fund to announce a suspension of its financial support for Argentina in late 2000—as had been done with a number of countries whose Fund-supported programs had gone persistently off track. However, the failures of Argentina to achieve the agreed-on fiscal objectives of its Fund-supported program in 2000 (as in 1999) were to a considerable extent attributable to the economy's weaker-than-expected performance.

For a country of the importance of Argentina that was making some constructive efforts to address its policy deficiencies, it would have been unusual—but not unprecedented—for the Fund to announce publicly a suspension of its support. However, unlike many countries where the Fund had announced interruptions in its financial support, Argentina appeared to be particularly vulnerable to potentially catastrophic consequences. Announcement of a suspension of Fund support might well provoke a financial crisis that would lead to sovereign default, a collapse of the Convertibility Plan, and financial and economic chaos. The Fund (and the international community more broadly) needed at least to consider other options.

One approach would have been to continue with an essentially standard Fund-supported program. Levels of official financial support would be within the normal boundaries for such programs; that is, up to 100 percent of its Fund quota (about $3 billion) plus additional moderate amounts from the World Bank and the Inter-American Development Bank. The policies under the program would involve preservation of the Convertibility Plan and would emphasize efforts at fiscal consolidation to contain public borrowing needs, reassure private creditors, and maintain market access.

The main difficulty with this approach was that, by late 2000, it seemed very unlikely to succeed because participants in international financial markets would see that it was clearly inadequate. Under this approach, Argentina would need to access international credit markets for substantial amounts of financing during 2001, even if it succeeded in achieving the fiscal objectives in a tough adjustment program. With financial markets skeptical about Argentina's medium- and longer-term fiscal sustainability, if such large-scale private financing were available at all, it would probably only be on terms so onerous that they would confirm market fears about fiscal sustainability. The likely outcome would be that Argentina would be forced into sovereign default and probable collapse of the Convertibility Plan some time in the first part of 2001. Thus, this approach appeared to be a polite way for the official community to abandon Argentina without explicitly saying so.

A second approach would have been to conclude that because of the continuing recession and the lack of political support, there was no real-

Institute for International Economics | http://www.iie.com

istic hope that the Argentine government could implement a fiscal policy that would avoid a messy sovereign default. Further official support for Argentina, within reasonable limits for such support, would not be adequate to avoid default. Instead, Argentine authorities should be advised that further official support would be available only on the condition that Argentina reach agreement with its private creditors that would substantially reduce its financing requirements in coming years—to an extent that would provide credible assurance that official support advanced by the Fund and other agencies would be repaid in a timely manner.

Necessarily, this rescheduling of private credits could not be entirely voluntary, because private creditors would be required to accept significant modifications of their existing claims that would reduce their market values. On the other hand, private creditors would benefit from the likelihood of a more favorable long-run outcome made possible by the continuation of official support (contingent on write-downs of private credits) and by the conditionality applied to the behavior of the Argentine authorities.

The main argument in favor of this second approach was that by late 2000 it was already likely that, sooner or later, Argentina would need to restructure its outstanding private credits in a less than fully voluntary manner. The alternative course, relying on further fiscal tightening to contain government borrowing and regain market confidence, might succeed; but the likelihood of such success was limited. Accordingly, it would be better to accept the damage likely to accompany any involuntary restructuring at a time when Argentina still had ample reserves—as well as additional support from the Fund and the official community—that could be used to help contain the damage from such a restructuring. In particular, if debt restructuring were pursued at this stage, there was at least some hope that the Convertibility Plan could be preserved, or that the mess associated with its collapse could be managed somewhat better than has actually turned out to be the case.

Moreover, the second approach would have been consistent with the principles just enunciated by the Fund's International Monetary and Finance Committee at its ministerial meeting in Prague. Once it became clear that a country could not reasonably be expected to continue servicing its private credits on their contractual terms, the Fund would continue to provide financial support only on the condition that a country seek a reasonable understanding with its private creditors that would reduce debt-service requirements to sustainable levels.

On the other hand, it had to be recognized that any effort by Argentina to restructure its private credits in a nonvoluntary manner would be viewed as a de facto sovereign default and would likely be very messy. If, as was not unlikely, a significant number of creditors refused to participate and pursued legal actions for collection, the process of resolving these disputes could drag on for years, and Argentina would be pre-

Institute for International Economics | http://www.iie.com

cluded from access to international credit markets for a protracted period. Very likely, in the face of de facto sovereign default, the Convertibility Plan would become untenable. The government's credibility would be seriously damaged, including the credibility of its commitment to maintain the Convertibility Plan. This would probably lead to a run on domestic money and bank deposits, leading to sharp declines in limited foreign exchange reserves and to a severe contraction of domestic credit. The solvency of, and confidence in, the domestic banking system would also be seriously impaired by de facto sovereign default, both from the direct effect of reductions in the value of government securities held by banks and from the effects of deposit runs and credit contraction as Argentines fled from all domestic assets of questionable value (including dollar-denominated deposits in Argentine banks).

Thus, a decision by the Fund in late 2000 to press Argentina into a debt restructuring that would have amounted to a de facto sovereign default would have been a very weighty matter. The Argentine government was dead set against such action. Argentina's private creditors would have been outraged. And, while it could be argued by late 2000 that a restructuring of Argentina's sovereign debt might become unavoidable, the evidence of its necessity by that stage was not yet overwhelming. Nevertheless, some in the official community appeared to favor this approach, or something close to it. This included those who were deeply opposed to large packages of official financial support, those who were especially (in my view, excessively) concerned with the possible moral hazard effects of such packages, and those who strongly favored the substantial involvement (and punishment) of private creditors as an essential counterpart for official efforts to help resolve major international financial crises.

At the Fund, however, there was little enthusiasm for this approach. Some recognized that there was a significant risk of sovereign default, collapse of the Convertibility Plan, and financial chaos (while others merely shuddered at such possibilities). But in the autumn of 2000, the Argentine situation was not seen as without realistic hope of a better outcome—especially if Argentine policy could be put on a better path. Sovereign default is an exceptionally serious step that should only be taken as a last resort. Sovereign default is also properly the decision of the government involved; the Fund (and the international community) should not press for such a decision except when there is clearly no other viable alternative. Similarly, reneging on the Argentine government's solemn commitment to maintain the Convertibility Plan was not something that the Fund could reasonably advise (under the threat of suspension of Fund support) as long as there was a reasonable chance that the system could be preserved and the Argentine authorities desired to pursue that chance.

The third approach—the approach actually adopted—was to proceed with a Fund-supported program for Argentina for 2001 with levels of support substantially greater than in standard Fund-supported programs (to

Institute for International Economics | http://www.iie.com

be achieved by a substantial augmentation of the substantial support already committed by the Fund under the existing three-year Stand-By Arrangement). As in the first approach, the policies under this program would emphasize fiscal consolidation, both in the deficit targets to be achieved for 2001 and in more fundamental measures (including better discipline on deficit spending by the provinces) to ensure fiscal sustainability in the longer term.

Under the program, the deficit target would be set so as to carefully balance the need to keep borrowing within responsible limits and show credible actual progress in achieving essential fiscal discipline against the very real economic and political difficulties of fiscal consolidation in a deepening recession. Official financing would be sufficiently generous to meet virtually all of Argentina's projected external financing requirements for 2001, assuming that the program's fiscal objectives were met. Official financing would be available on a more limited basis to meet part of projected external financing needs for the subsequent two years. (The headline figure for financial support associated with the program was almost $40 billion, with about $14 billion from the Fund, $5 billion from the Inter-American Development Bank and the World Bank, and $1 billion from the government of Spain. According to the Fund, the package also included ". . . about $20 billion of financing from the private sector that relies on a market-based, voluntary approach intended to complement Argentina's objective of assessing international capital markets as soon as confidence returns" [Fund Press Release 01/3, 12 January 2001]. This money, however, was not effectively committed to support Argentina; it was likely to come only if the program succeeded.)

The objective of this third approach was to give Argentina one last chance to avoid the catastrophe likely to ensue from sovereign default and a probable collapse of the Convertibility Plan. Success was not assured even if the Argentine government lived up fully to its policy commitments; success was highly doubtful if there was any substantial policy failure, especially in the critical fiscal area. But the international community, led by the Fund, at least was pledging a level of financial support that offered a further window of opportunity to demonstrate a willingness and ability to pursue the difficult measures necessary to attain fiscal sustainability. Also, the international community would be sending an important signal by pledging support to Argentina on a scale similar to that of other important countries that had faced severe international financial crises in recent years; whereas significantly less generous support for Argentina would likely be seen as quite a negative signal.

Moreover, from the perspective of the Fund, a substantial support package for Argentina could be seen as consistent with the general principle of "uniformity of treatment," which is one of the basic tenets that is supposed to govern all of the Fund's activities. Unless Argentina was, for some substantive reason, significantly less deserving than other members

Institute for International Economics | http://www.iie.com

that had received large support packages or could reasonably be judged to be significantly less likely to succeed in its stabilization efforts, the principle of uniformity of treatment argued that Argentina should be given a last chance to avoid catastrophe—with a level of international support (subject to appropriate conditionality) consistent with that made available in other roughly similar cases.

In retrospect, because the Argentine case has ended in sovereign default and a messy collapse of the Convertibility Plan, one might reasonably argue that an earlier move toward this alternative would have done no harm and might have done some good. The latter would be the case if the resources from the international community used to attempt to avoid the collapse were instead conserved to help deal with its consequences, or if the collapse would have been better managed if undertaken in an earlier, better-planned manner. Indeed, I shall argue below that one of the important costs of the (in my view, misguided) decision to augment Fund support for Argentina in the summer of 2001 was precisely that this support was wasted on what was already clearly a lost cause. Was this not also the case with the decision in December 2000 that initiated Fund support for Argentina on an exceptional scale? Was not that key decision also a serious mistake?

The answer depends primarily on the assessment, in late 2000, of whether Argentina still had a realistic chance of avoiding de facto sovereign default and a likely collapse of the Convertibility Plan—which would surely have very dire consequences, including a potential collapse of the financial system—and whether the Argentine authorities were prepared to pursue policies that offered reasonable hope of realizing that chance. Indeed, after extended deliberations in official bodies (and probably with Argentina partly in mind), the Fund's International Monetary and Finance Committee set forth, in the communiqué of its 24 September 2000 ministerial meeting in Prague, the options to be considered and the considerations to be weighed in situations where a country faced a possible disruption in its payments to private creditors:

> The Committee agrees that the operational framework for private sector involvement must rely as much as possible on market-oriented solutions and voluntary approaches. The approach adopted by the international community should be based on the IMF's assessment of a country's underlying payment capacity and prospects for regaining market access. In some cases, the combination of catalytic official financing and policy adjustment should allow the country to regain full market access quickly. *The Committee agrees that reliance on the catalytic approach at high levels of access presumes substantial justification, both in terms of its likely effectiveness and of the risks of alternative approaches.* In other cases, emphasis should be placed on encouraging voluntary approaches, as needed, to overcome creditor coordination problems. *In yet other cases, the early restoration of full market access may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile. This includes the possibility*

Institute for International Economics | http://www.iie.com

that, in certain extreme cases, a temporary payments suspension or standstill may be unavoidable. [emphasis added]

Stripping out the bureaucratic mumbo jumbo, a decision to commit large-scale assistance from the Fund should depend on the likelihood of a program's success and the likely consequences if the program failed and the country was forced into a de facto default and restructuring of its debts to private creditors. Though skeptical that the chance of success was as great as 50 percent, my view was (and is) that in late 2000 there still was a reasonable chance that what would otherwise be an economic and financial disaster of great magnitude could be avoided—if the Argentine government assiduously implemented fiscal measures that reassured private creditors about longer-term debt sustainability.[1]

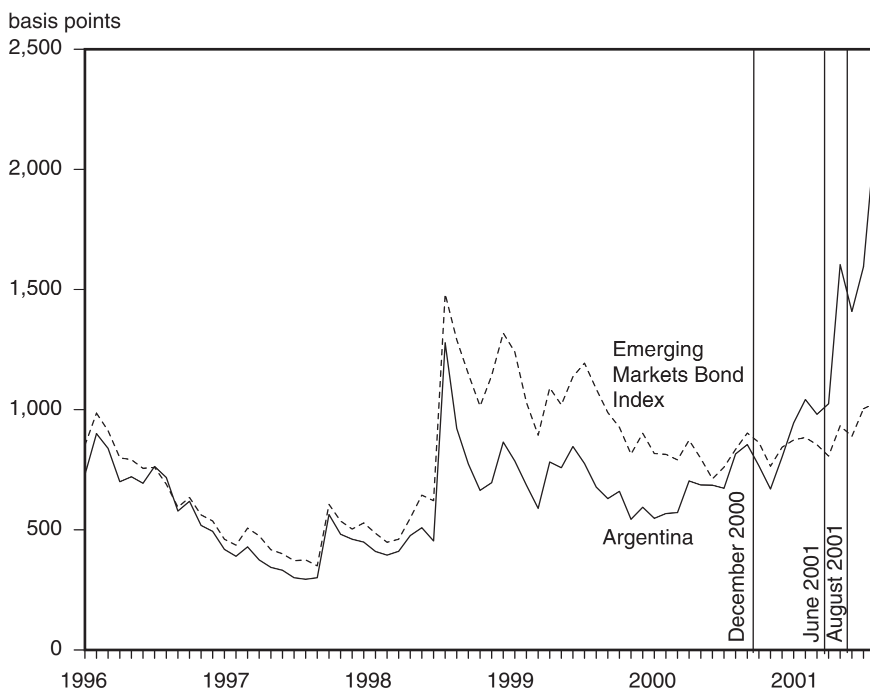
Evidence supporting this assessment included the fact that Argentina still had ample international reserves, with a significant margin above the size of the domestic monetary base. Indeed, the loss of reserves that Argentina sustained between late summer and mid-November 2000 was recovered as negotiations on a new Fund-supported program progressed. Also, despite a modest downturn from October to December, deposits in Argentine banks remained near their peak level and, in light of the weak economy, signs of stress in the banking system were quite limited. There had been no major runs on Argentine banks or other clear signs of a domestic collapse of confidence in the sustainability of the Convertibility Plan or in the solvency of the government. Externally, there was the hope in late 2000 that the evident slowdown in the US economy might lead to both an easing of monetary policy in the United States and a downward correction of the US dollar against the euro, each of which would help Argentina (as had happened in the tequila crisis in 1995).

In international capital markets in late 2000, interest rate spreads on Argentine sovereign debt had risen to about 750 basis points above US Treasuries, up from about 550 basis points a year earlier; see figure 3.1. And interest rate spreads on Argentine bonds in late 2000 had risen modestly and briefly above the average spread for emerging-market borrowers. This indicated rising concern about fiscal sustainability in Argentina, but not yet firm conviction that sovereign default was virtually inevitable. In fact, Argentina had survived the Brazilian crisis of late 1998 and early 1999 when spreads on Argentine sovereign debt had briefly breached 1,000 basis points and subsequently rose briefly to 800 basis points on two occasions, before falling back to more moderate levels.

1. Contrary to normal practice and protocol in the Fund, I was not kept informed about discussions with the Argentine authorities in November and December 2000 and was not consulted by Fund management in advance of its decision to recommend a large assistance package for Argentina. Accordingly, the view that I now take of that operation is not influenced by the position that I took in my official capacity at the time.

Institute for International Economics | http://www.iie.com

Figure 3.1 Interest rate spreads on Argentine sovereign debt and the Emerging Markets Bond Index



Note: End-of-month values.

Source: Economic Ministry of Argentina.

Indeed, relatively straightforward calculations indicate that at interest rate spreads of 500 to 600 basis points, Argentina's debt dynamics could have been sustainable under achievable degrees of budget discipline; whereas at persistent interest rate spreads of 1,000 basis points or more, the situation would be virtually hopeless. Formally, the condition of fiscal sustainability—that the ratio of pubic debt to GDP should not be rising persistently—may be stated as the condition that the ratio of the primary budget surplus to GDP, b, must be greater than or equal to the ratio of debt to GDP, d, multiplied by the difference between the interest rate on government debt, r, and the growth rate of the economy, g; that is, b must be greater than or equal to d times r minus g.

For Argentina in 2000–01, the ratio of public debt to GDP was about 50 percent, and for reasons discussed above, persistent increases above this ratio were not sustainable. Interest rates on medium-term US Treasuries in late 2000 were running around 5.5 percent, implying that with a spread of 550 basis points above US Treasuries, r would be about 11 percent. At

Institute for International Economics | http://www.iie.com

this level of interest rates, prior experience suggests that the Argentine economy would probably be able to grow at a moderate pace, with little or no price inflation—say a growth rate of nominal GDP, g, of 4 percent a year. All of this suggests that a primary budget surplus, b, of about 3.5 percent (equal to 50 percent times the difference between 11 percent and 4 percent) would have been required for fiscal sustainability. A primary fiscal surplus of 3.5 percent of GDP would have been ambitious in an Argentine economy mired in deep recession. However, a successful effort to produce a consolidated budget surplus of 2 percent of GDP in the midst of recession might have established market confidence about what would be achieved in more normal economic circumstances.

In contrast, at interest rate spreads of 1,000 basis points above US Treasuries, r would have been at least 15 percent. At this level of interest rates, it would have been difficult for the Argentine economy to achieve much real growth, and deflation probably would continue at a modest pace. This suggests that g, the growth rate of Argentine nominal GDP, would have been about zero. Under these conditions, the primary budget surplus, b, would have to be at least 7.5 percent of GDP (equal to 50 percent times 15 percent minus zero) to achieve fiscal sustainability. It is inconceivable economically, and especially politically, that Argentina could have achieved a primary budget surplus of near this magnitude; and the economic effect of attempting to do so would likely have deepened the recession. Thus, sustained interest rate spreads above 1,000 basis points would be a clear signal that Argentina was headed for sovereign default.

With interest rate spreads rising to 750 basis points in late 2000, there was an urgent need for action to persuade financial markets that the Argentine government would find its way out of its fiscal difficulties and thereby induce a reduction in interest rate spreads to a level more plausibly consistent with fiscal sustainability and economic growth. But the situation did not appear hopeless. With determined action by the Argentine authorities and a pledge of substantial support from the Fund and the international community, there was still a realistic chance of success. However, if these efforts faltered or failed and interest rate spreads rose significantly, this would signal an irreparable loss of market confidence, and the game would almost surely end in tragedy.

Two other approaches to Argentina's difficulties might also have been considered in the autumn of 2000. President Menem and some in his administration had mused about moving from the Convertibility Plan to full dollarization—that is, replacing the peso completely with the US dollar. However, President de la Rua and his administration did not favor this approach. Even if moving to dollarization had been feasible and potentially desirable, it would have been inappropriate for the Fund to press a sovereign member for such a fundamental change in its monetary regime.

Another approach would have been a very big bailout that would have provided the Argentine government with guarantees of official support

Institute for International Economics | http://www.iie.com

sufficient to cover its prospective financing requirements for several years, with repayment spread out many years into the future. However, this would have meant a substantial escalation in the magnitude and duration of official financing packages, and there was no support for this among the major countries that provide the Fund's resources. Indeed, following the controversies over previous large support packages, there was a consensus to move in the other direction: toward more modest amounts of official support and toward more consistent efforts to involve private creditors in the resolution of financial crises, including, when necessary, through involuntary sovereign debt restructurings.

Losing It

Argentina enjoyed a very brief period of respite in early 2001. On 3 January, Argentina got a boost as the US Federal Reserve cut US short-term interest rates and signaled the likelihood of further cuts. On 12 January, the Fund's Executive Board formally approved the augmentation of the Fund's Stand-By Arrangement for Argentina and authorized immediate disbursement of about $3 billion. Aided by these developments, spreads on Argentine sovereign debt fell to about 650 basis points, and the Argentine authorities took advantage of renewed access to international credit markets to float a large eurobond issue.

Unfortunately, however, Argentina's respite was short-lived. Political turmoil in Turkey helped to undermine confidence in that country's efforts to defend its crawling-peg exchange rate, which collapsed in a messy crisis in February; and contagion from this crisis was reflected in an increase in spreads for the Argentine sovereign. More important for Argentina, things were not going well at home. Fiscal results for the Argentine government for the fourth quarter of 2000 would likely reveal failure to meet the fiscal targets for the end of 2000.

This failure might, once again, be swept under the rug. But with revenues coming in well below program assumptions (due partly to the recession and partly to deteriorating tax compliance) and expenditures not particularly well contained, by February, fiscal results for the first quarter of 2001 also appeared at risk of exceeding program targets; and this would be impossible for the Fund to ignore. The deteriorating fiscal situation led to renewed concerns about Argentina in financial markets and to a renewed widening of spreads. The likely need to adopt additional measures of fiscal tightening to meet program targets heightened political tensions with the Peronist opposition in the Argentine Congress, with provincial political leaders, and within the Argentine government.

With dissension in the Argentine cabinet focused on economy minister Luis Machinea, President de la Rua decided to make a change in the head of his economic team. Ricardo Lopez-Murphy—a well-known Argentine

Institute for International Economics | http://www.iie.com

economist who had been educated at the University of Chicago—was selected as the new economy minister. Within days, he proposed new measures of fiscal consolidation, focused on sharp reductions in public spending, to address the Argentine government's deteriorating fiscal position. Argentine politicians of all parties and ranks were outraged, including most of Lopez-Murphy's fellow ministers. The president refused to back his new economy minister and sided with the vast majority of Argentine politicians.

In my view, this event marked the effective end to any realistic hope that the Argentine government would address its fiscal difficulties with sufficient resolve to avoid sovereign default and its attendant chaos. In February, interest rate spreads on Argentine sovereign credits rose to 850 basis points and generally fluctuated between this level and 1,050 basis points through the spring. At this level of spreads, there was little hope either that the Argentine economy could begin a sustained recovery or that the debt dynamics of the Argentine sovereign could be put on a sustainable path.

Moreover, it was becoming increasingly clear that resolution of Argentina's potentially unstable debt dynamics through fiscal tightening was neither politically feasible nor economically sensible. On the political side, fiscal tightening is particularly difficult when a country is already in deep recession, and especially so in the Argentine system where the provinces can easily undermine the central government's austerity efforts. On the economic side, fiscal tightening in the midst of a deep recession tends to forestall economic recovery, which is essential to put debt dynamics on a sustainable path. Recognition of these difficulties made financial markets particularly sensitive both to political difficulties in achieving fiscal austerity and to adverse news on the performance of the Argentine economy. Once financial markets became persuaded that Argentina had no viable way out of this predicament, fears of sovereign default would become self-fulfilling.

After the departure of Lopez-Murphy, President de la Rua next called on the legendary Domingo Cavallo, author of the Convertibility Plan and genuine hero of Argentina's stabilization and reform efforts in the early 1990s, to resume his old post of economy minister. With his characteristic energy, Minister Cavallo rapidly secured Parliamentary approval for wide (but not unlimited) powers of the president to enact economic measures by decree.

Cavallo—eschewing the Lopez-Murphy approach of fiscal consolidation through expenditure restraint—focused primarily on taxes. A financial transactions tax (initially at a 0.25 percent rate and later raised to 0.4 and then 0.6 percent) was introduced to raise significant additional revenue. Some other measures sought to raise revenue, whereas others sought to spur investment and growth at the expense of revenues. The overall intended effect was to raise revenues—not enough to reach the original

Institute for International Economics | http://www.iie.com

deficit targets for the first quarter of 2001, but enough to suggest that an upwardly revised deficit target for the second quarter could be met and that the original deficit target for the end of 2001 could still be attained.

In evaluating these measures vis-à-vis the agreed-on objectives in the Fund-supported program, the Fund's decisions were governed by its long-standing policies and practices. It is not infrequent that Fund-supported programs go off track and fail to meet their previously agreed-on objectives (spelled out in Fund conditionality). When this happens, the Fund member is almost always allowed to propose corrective policies which, if they offer the reasonable expectation of returning performance to the original program objectives, lead to a Fund decision to continue scheduled disbursements under the program. This is what happened for Argentina. In view of the new fiscal measures, violation of the fiscal target for the first quarter of 2001 was waived and the disbursement for that quarter (after a short delay) was made. The fiscal deficit target for the second quarter was revised upward somewhat, whereas the original fiscal deficit target for the end of 2001 ($6.5 billion) was maintained.

Notably, the key issue of whether the Fund-supported program for Argentina still had any realistic chance of avoiding de facto default and a likely collapse of the Convertibility Plan was not seriously addressed at this time. (The IMF Staff Report on Argentina of 14 May 2001, publicly released as IMF Country Report 01/90, contains an analysis of Argentina's debt dynamics. This analysis is examined in appendix A.) This was consistent with Fund practices going back 50 years. By the decision made by Fund management in December 2000 and ratified by the Executive Board in early January 2001, the Fund was effectively committed to continue disbursements under the program for Argentina as long as the Argentine authorities were making reasonable efforts to meet their policy commitments under that program. By March 2001, financial markets had apparently concluded that these efforts no longer had much chance of success; and this conclusion would very likely prove to be a self-fulfilling prophecy. Nevertheless, the Fund could not reasonably back out of a commitment it had already made to support Argentina's efforts to avoid a disastrous financial and economic crisis.[2] Indeed, a signal from the Fund that it would not continue with the support it had already committed to Argentina, despite the government's efforts to repair their program, would very likely have provoked that crisis.

2. Discussions by the Fund's Executive Board of the principles and policies that govern Fund support for members, especially in the context of Stand-By Arrangements, go back to the early 1950s. The conclusions of these discussions (and their implementation in actual cases) constitute an essential part of the "law of the Fund" which exerts great influence on how the Fund operates. From the start of these discussions, it has been recognized that once the Fund has committed its support, members must be able to rely on that support, provided that they are meeting its agreed-upon conditions.

Institute for International Economics | http://www.iie.com

In the face of deteriorating market confidence during the spring of 2001, Minister Cavallo pursued numerous new initiatives. These initiatives were often announced without consulting in advance with the Fund or even with most of his own staff. His actions in three areas are particularly noteworthy. In mid-April, he suddenly announced a change in the Convertibility Plan. Rather than being pegged at parity to the US dollar, the peso would instead be pegged 50 percent to the dollar and 50 percent to the euro. Initially, the new exchange rate would apply only to international trade transactions (and not to capital flows or services), and it would be implemented by a system of taxes on imports and subsidies to exports to avoid creating a "multiple exchange rate practice" that violated Argentina's commitments under the Fund's Articles of Agreement. Because Argentina trades about as much with the euro area as with the United States, the economic rationale for this initiative is an arguable issue. However, the effect on confidence in financial markets of the announcement of a change in the Convertibility Plan was clearly quite negative—at a time when confidence in financial markets was of critical importance for Argentina.

A second Cavallo initiative of spring 2001 concerned the Argentine Central Bank and its governor, the widely respected Pedro Pou. Governor Pou was not a fan of Minister Cavallo's efforts to adjust the Convertibility Plan or his desires to reduce the liquidity reserves that banks were required to hold and thereby have the central bank pursue a more accommodative monetary policy by stretching the limits of what was allowed under the Convertibility Plan. Both issues were debatable as to their economic merits. But the decision on these issues was within the province of the independent central bank, and Governor Pou was well within his legitimate authority to determine the decision—subject to his interpretation of the requirements of the Convertibility Plan.

As an important guarantee of the effective independence of the central bank, its governor could be removed only for cause, not at the whim of the economy minister or even the president. Cause was conveniently found; Governor Pou was accused of serious misconduct by failing to prevent certain money-laundering transactions by some Argentine branches of foreign banks. Whatever the merits of this accusation, it achieved its desired effect in securing the removal of Governor Pou. However, the effective independence of the central bank was clearly compromised and confidence in financial markets was further undermined, dealing another blow to confidence both domestically and internationally.

The third, and perhaps most important, Cavallo initiative was the large swap of Argentine government debt that was carried out at the end of May. This swap was voluntary, at least from the perspective of external holders of Argentine sovereign debt; it was not carried out under the threat of default—although worries about possible default clearly depressed the market value of Argentine sovereign debt at this time. The

Institute for International Economics | http://www.iie.com

effect of the swap was to exchange nearly $30 billion of the face value of existing Argentine sovereign debt (including about $8 billion held externally) for new sovereign obligations. Interest and principal payments due between 2001 and 2005 were substantially reduced by the swap, at the expense of substantially higher interest and principal payments due over the next 25 years.

The debt swap was characterized as an important success by the Argentine government and its financial advisers (who earned substantial fees). It was a success at least in the limited respect that a substantial volume of debt was offered for exchange both by Argentina's domestic and foreign creditors. Indeed, an upward move in interest rate spreads attributable to fears that the offered swap would be a market flop was at least briefly reversed when the volume of tendered securities proved larger than expected.

However, a proper analysis of the effects of the swap for Argentina cannot be based on whether its creditors found the terms of the swap sufficiently attractive to motivate them to tender. Rather, the swap was a good deal for Argentina only if the benefits from the reductions in debt service during the period 2001–05 outweighed the costs of the additional debt-service obligations in later years. This, of course, is not a simple arithmetic comparison. With positive interest rates, the net (undiscounted) cost of a swap that lengthens the average maturity of the debt (by about three years, in the case of the Argentine swap) will be positive even for a deal that is quite beneficial from an Argentine perspective. The issue is how high a price is being paid to achieve a given increase in the maturity of the debt.

At the time the swap was carried out, the interest rate spread of Argentine sovereign bonds over US Treasuries was between 900 and 1,000 basis points, corresponding to an interest rate on Argentine sovereign debt of between 15 and 16 percent. Because holders of Argentine debt already had the opportunity to trade in the market Argentine debt of lower maturities for debt of higher maturities at these interest rates, they surely would not voluntarily accept an officially sponsored swap at less attractive terms. Consistent with this fact, in the swap, the Argentine government achieved a reduction in its debt-service obligations between 2001 and 2005 of only about $12 billion, at the expense of additional debt-service obligations of about $66 billion in the years beyond 2005.

Not surprisingly, in view of the level of market interest rates, it takes a discount rate of more than 16 percent to make the present value of this swap break even from the Argentine government's (and citizen's) perspective. This is a very high discount rate to apply for a country that (under the assumption that the Convertibility Plan is maintained) is not likely to enjoy an annual growth rate of GDP (measured in US dollars) that consistently exceeds 7 percent.

Indeed, as was argued above, interest rates for the Argentine sovereign of 16 percent (interest rate spreads of above 1,000 basis points) were not

Institute for International Economics | http://www.iie.com

consistent with positive growth of the Argentine economy or with debt sustainability. By pursuing and accepting a debt swap on such onerous terms, the Argentine government was effectively declaring that it shared the market's assessment that sovereign default was virtually inevitable. Thus, the debt swap on these terms is properly viewed as an act of desperation by a debtor that is prepared to promise almost anything in the long term for relatively modest debt-service relief in the near term.

The Fund issued a very brief public statement that "welcomed . . . the announcement by the Argentine government of the successful conclusion of the debt exchange offer . . ." In the circumstances, it could hardly have done otherwise. However, beyond this statement, the Fund staff made a broader effort to analyze the consequences of the debt swap in depth and reach conclusions concerning its costs and benefits for Argentina. Notably, in much of this effort there was a tendency to portray the debt swap in the best possible light for the Argentine authorities that had undertaken it, rather than to recognize the simple truth that modest short-term debt-service relief had been secured at very high cost in terms of long-term debt-service obligations. This was symptomatic of the general tendency in the Fund to try to see things in the best possible way from the perspective of the member and its authorities.

Chutzpah

After a brief respite following the introduction of new measures to improve the fiscal balance and agreement on a somewhat revised program with the Fund (and disbursement of the tranche of Fund support due for the first quarter), sharp upward pressures on interest rate spreads for Argentine paper reemerged in late June and July 2001. One worry was that tax revenues were coming in below forecasts, raising concerns that even the revised fiscal targets for the second quarter might not be met. Probably more important, large-scale withdrawals of deposits from Argentine banks, which had been halted and partially reversed in the spring, resumed in July as Argentines became increasingly concerned about a possible breakdown in the Convertibility Plan. Also, the Argentine government was running very short of cash—a fact that the general public may well have surmised from widespread reports of delays in government payments, including transfers to provincial governments. With deposit runs accelerating and interest rate spreads spiking to 1,500 basis points above US Treasuries, something needed to be done quickly, or the game was about to end.

Through leaks to the local press, the Argentine government circulated the story that the Fund would accelerate its normal schedule for (favorable) consideration of its disbursement of about $1.25 billion, on the basis of satisfactory performance through the end of the second quarter. More

Institute for International Economics | http://www.iie.com

important, the Fund would augment this disbursement with an addition of about $8 billion. Financial markets reacted positively to this news, and the bank runs slowed. A little later on, Minister Cavallo announced that, in conjunction with the augmented Fund support, the Argentine government would pursue a more ambitious fiscal policy—with the objective of reducing the fiscal deficit to zero from then onward. However, announcement of a zero-deficit plan did not assure its approval or, even more important, any realistic chance of its successful implementation. With the Argentine economy already in deep recession and spiraling downward under the pressure of crushingly high interest rates, the massive additional fiscal tightening needed to achieve a zero deficit was neither politically acceptable nor economically sensible. By the summer of 2001, the Argentine government was clearly trapped with no viable avenue of escape.

Nevertheless, Cavallo pressed on with his initiative in classic Cavallo style. The suggested augmentation of Fund support was announced without consultations with the rest of the Argentine government. Even some key Cavallo aides were taken by surprise. There were no prior consultations with the Fund, nor any prior indication of support from the Fund for a substantial augmentation of its lending. Indeed, Cavallo's tactic was to force the Fund to augment its lending by creating a fait accompli. Financial markets and Argentine citizens reacted favorably to the announcement of augmented Fund support. If they were disappointed that this support was not forthcoming, the Fund (and the international community more broadly) would be responsible for the consequences.

For those not familiar with how the Fund normally operates, it may be difficult to understand how great a perversion of its policies and principles was perpetrated in this incident. The Fund is not an aid agency; it does not give money to countries to ease their economic and financial distress. The Fund lends money to countries in support of a well-defined set of economic policies, especially monetary, fiscal, and exchange rate policies. The objective of such lending is to assist the country in meeting its international payments obligations, while that country is undertaking policies that give credible assurance that payments imbalances will be corrected—in a manner that avoids, to the extent possible, damage to national and international prosperity. To merit Fund support, a critical requirement of any policy program is that it must provide reasonable assurance that the resources lent by the Fund will be repaid in a timely manner.

In recommending a Fund-supported program for approval by the Fund's Executive Board, the managing director certifies that he is confident that the policies promised by the national authorities in their Letter of Intent to the Fund will be responsibly implemented and that under these policies there is credible assurance that the Fund will be repaid. The amount of resources pledged by the Fund to support a member's policies and the phasing of their disbursement is determined by the managing director (as his recommendation for approval by the Executive Board) at the

Institute for International Economics | http://www.iie.com

end of negotiations over the program, on the basis of his assessment of the country's financing need and of the strength of the country's policy program. It has never been acceptable for a country to decide by itself the size of support it will receive from the Fund and to seek to impose its wishes through the fait accompli of a public announcement.

The Fund's emergency assistance to Russia during the summer of 1998 is a case in point. The Fund had an ongoing program with Russia, within the standard limits of Fund financing. During the first half of 1998, Russia's financial situation deteriorated sharply as its current account went into deficit (due partly to weakening world oil prices) and interest rates on the government's domestic-currency debt escalated as creditors became increasingly worried about potential default. The policy performance of the Russian government under the Fund-supported program since early 1996 had been—to put it politely—less than entirely satisfactory, especially in controlling the fiscal deficit.

Nevertheless, Russia was clearly a very important case, and there were important reasons, perhaps more political that economic, to give its government a last chance to avoid the chaos likely to result from devaluation or default. The managing director of the Fund, Michel Camdessus, took the initiative. He proposed a large augmentation of the Fund's support for Russia (beyond normal access limits) and arranged with the Fund's leading members to activate the General Agreements to Borrow in order to supply the Fund with additional liquidity to underwrite the operation.

For its part, the Russian government was required to strengthen its policy program, especially in the fiscal area. Indeed, before the approval of the augmented program and disbursement of the initial tranche of augmented support (about $5.5 billion out of a total of about $15 billion), the Russian government was required to implement a number of prior actions, including passage of certain legislation by the Russian Duma. When the Duma refused to pass two key measures, the Fund's managing director cut back the size of the initial disbursement by about $800 million. Neither the Russian government nor many of its political supporters were pleased with this decision, and financial markets reacted negatively. But the managing director had the authority to set access to Fund resources (subject to later approval by the Executive Board), and he was determined to show that the Fund was serious about its conditionality in a situation where determined action by the authorities was absolutely essential to restore market confidence and to provide some hope for the success of the program.

For Argentina, the December 2000 support package (approved by the Executive Board in January 2001) involved a large augmentation to an already existing Fund-supported program, beyond the normal limits of access. Similar to the July 1998 package for Russia, this December 2000 package for Argentina was supposed to support a last chance to strengthen its policies and avoid a catastrophe. By the summer of 2001, that last-chance

Institute for International Economics | http://www.iie.com

effort was clearly failing. Yet, at its own initiative, the Argentine government was insisting on substantial additional support for a second last chance—perhaps to be followed by more last chances down the road.

Not only was the procedure unusual; the outcome—a Fund disbursement of more than $6 billion (announced in August and formally approved in early September), with a pledge of $3 billion more to support an unspecified debt restructuring—was extraordinary both in its size and in the lack of any reasonable justification. The disbursement was the second largest in Fund history. About $1.25 billion was the amount due for Argentina upon successful completion of the review of its performance through the end of the second quarter. It was reported that Argentina met the quantitative criteria of the Fund-supported program—most important, keeping the fiscal deficit within the revised limit permitted for that quarter. But the target on the cash deficit was met with the aid of substantial payment arrears: tax rebates under the value-added tax and export incentive schemes were delayed; transfers due to the provinces were withheld; and payments for government wages, pensions, and health and welfare benefits were deferred.

Under the Fund's traditional three-monkeys approach to assessing a member's performance—hear no evil, see no evil, speak no evil—such transgressions would often be ignored. As with the disbursement in May, the long-standing Fund policy of continuing disbursements under an already agreed-on program (provided that the member is meeting the explicit requirements of Fund conditionality) might reasonably have justified proceeding with the already scheduled disbursement of about $1.25 billion.

On the other hand, the Fund's decision on disbursement of the scheduled tranche was supposed to be based on a "program review"—which, in addition to a narrow appraisal of the satisfaction of quantitative performance criteria for the end of the second quarter, generally called for a forward-looking assessment of whether the program was on track and likely to meet its objectives at least through the end of the program year. With the Argentine economy performing well below the economic assumptions of the program, with interest rate spreads at levels (about 1,500 basis points) that clearly implied deepening recession and continuing deflation, and with no realistic chance of actually implementing fiscal measures that would (in these economic circumstances) come close to achieving the year-end deficit limits, an honest forward-looking assessment would have concluded that the program was headed irreparably off track. Such an assessment, perhaps reinforced by some critical reference to the substantial payments arrears that were used to meet the formal performance criteria for the end of the second quarter, ought to have sufficed to overturn the usually strong presumption that the Fund would continue with scheduled disbursements under an already established program (subject to nominal compliance with the explicit performance criteria).

Institute for International Economics | http://www.iie.com

More important, a large augmentation of the program (the disbursement of an additional $5 billion and the pledge of $3 billion more to support debt restructuring) clearly called for a de novo assessment of the entire Argentine program—as was done at the time of the December 2000–January 2001 decision to augment substantially Fund support for Argentina. Was there a reasonable expectation that the Argentine authorities would be able to implement the policies to which they were committed under the program; and, if so, was there a reasonable expectation that the program would succeed, especially in the key requirement that Argentina would be able to repay the Fund in a timely manner?

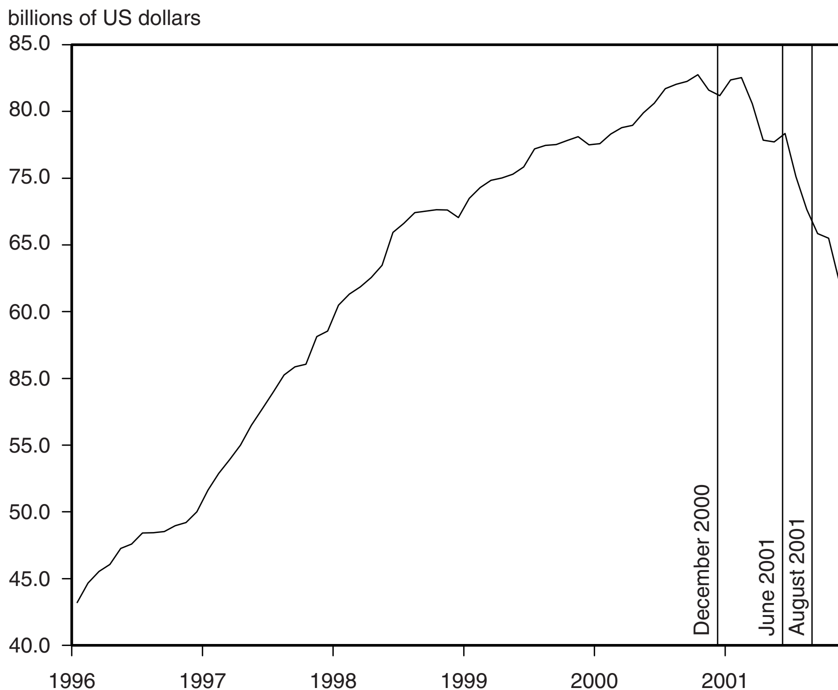
Arguably, in December 2000, it had been possible to answer these critical questions in the affirmative. Interest rate spreads for the Argentine sovereign had risen sharply to about 750 basis points, up from about 550 basis points a year earlier. With the commitment of a new, large package of international support, with determined and credible actions of the Argentine authorities to contain this deficit within responsible limits, and with some good luck (such as a shift by the US Federal Reserve toward monetary easing), there was at least a reasonable chance that a disastrous default and likely collapse of the Convertibility Plan might be avoided. Financial market confidence in Argentina could improve, allowing renewed market access at significantly reduced interest rate spreads. With capital-market access restored and interest rates reduced, economic recovery could begin and fiscal sustainability could be achieved with a politically feasible degree of budgetary restraint. Indeed, as was noted above, in January 2001, after formal approval of the new international support package and a clear signal of a shift toward an easing of US Federal Reserve policy, Argentina appeared, at least briefly, to be moving along this desirable course.

By August 2001, however, prospects for a favorable outcome were pure fantasy. In contrast to the situation eight months earlier, successive runs on Argentine banks had reduced bank deposits by more than $10 billion; see figure 3.2. Argentina also had suffered substantial losses of foreign exchange reserves (especially abstracting from the inflows of reserves from disbursements of Fund support); see figure 3.3. Most important, interest rate spreads for the Argentine sovereign had risen persistently above 1,000 basis points and were generally fluctuating in the range of 1,300 to 1,600 basis points. This implied nominal interest rates for the Argentine sovereign (which generally set the lower bound for other Argentine credits) of 18 to 22 percent, with real interest rates even higher due to deflation.

Economic recovery was impossible in this situation; and nominal GDP would surely continue to contract even more rapidly than real GDP, implying significant increases in the ratio of debt to GDP even if, by some miracle, the government budget were brought into overall balance. The Argentine government's fiscal policy, with its increasing reliance on unsustainable payments arrears, clearly could not meet its targeted objec-

Institute for International Economics | http://www.iie.com

Figure 3.2 Total bank deposits in Argentina, 1996–2001



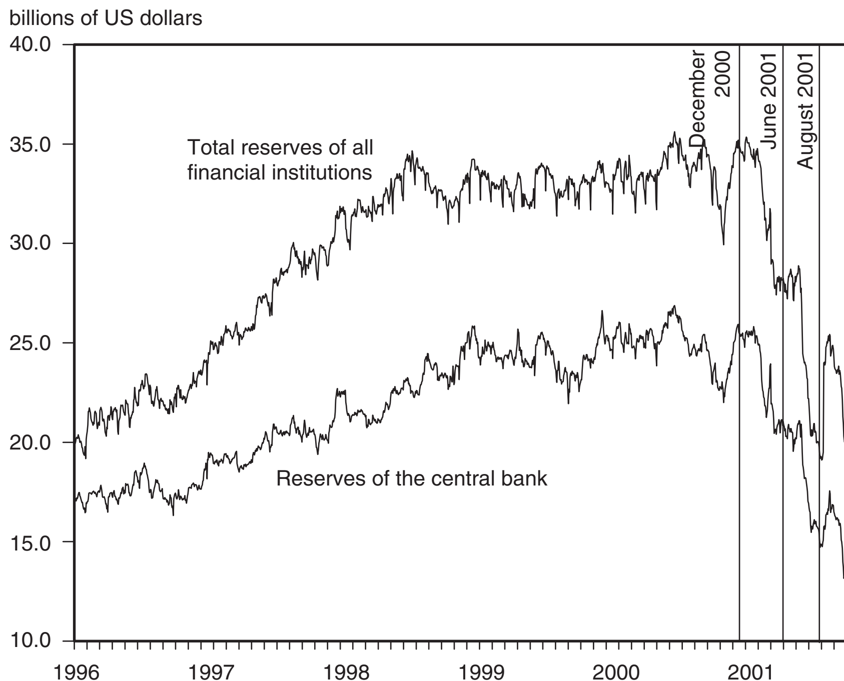
Source: Central Bank of Argentina.

tives. The political consensus to raise the huge primary surplus that would be required to demonstrate sustainable debt dynamics in these circumstances was, quite understandably, nowhere apparent and never likely to materialize. Substantial reserve losses had already occurred, and further bank runs were a continuing threat. An emergency injection of another $6 billion in cash from the Fund was urgently needed just to stave off immediate default and keep the farce going for another few months. If announcement of a large package of international support had helped to bring only brief respite in the relatively favorable circumstances of January, it was absurd to believe that a more modest augmentation of that package by another $5–8 billion would somehow produce a miracle in the clearly desperate circumstances of August. Looking at the facts, a wide range of analysts outside the Fund (and several at the Fund)—often with differing views on many issues—clearly concluded that the game was over for Argentina. Only a fool would conclude otherwise.

Why, then, did the Fund, and the international community more broadly, acquiesce in this folly? Both at the Fund and outside it, there was rightly a great deal of concern about the deteriorating situation in Ar-

Institute for International Economics | http://www.iie.com

Figure 3.3 Foreign exchange reserves in Argentina, 1996–2001



Source: Central Bank of Argentina.

gentina and about the disaster that would accompany a sovereign default and a likely simultaneous collapse of the Convertibility Plan and the Argentine financial system. Also, Argentina was generally seen as a country deserving of sympathy and support; and the Argentine authorities were certainly willing to draw on this sympathy and support. US President George Bush publicly expressed the concerns of his administration and its support for further assistance to Argentina. UK Prime Minister Tony Blair traveled to Argentina to emphasize similar views on the part of his country. German Chancellor Gerhard Schröder and the senior political leaders of many other European countries also voiced their concerns and support. And, beyond the genuine sympathy that was felt for Argentina, there was undoubtedly the desire, both inside and outside the Fund, to avoid the appearance of responsibility for Argentina's collapse.

In fact, however, the Fund's large September disbursement would do no more than postpone the catastrophe in Argentina by three months. This was known or should have been apparent to the top officials in the Fund and among the Fund's major members that together determined how the Fund would respond to Argentina's request for augmented support. Here there was a failure of intellectual

Institute for International Economics | http://www.iie.com

courage—to face up to the realities of the situation in Argentina—and a failure of moral courage—to make the difficult decision to decline substantial additional support for policies that no longer had any reasonable chance of success.

Argentina was not helped. Indeed, external assistance that was potentially far more valuable in helping to contain the damage once a de facto sovereign default had occurred was instead squandered in a futile effort to avoid the inevitable. And a last opportunity to persuade the reluctant Argentine authorities to face very unpleasant realities and prepare for a potentially more orderly (although still difficult and dangerous) retreat was lost. Indeed, through the autumn of 2001 and until early December, the Fund maintained a dialogue with the Argentine authorities on the assumption that the measures needed to implement Cavallo's zero-deficit policy (including the cooperation of the provinces) might somehow be implemented and that Fund disbursements related to performance through the third quarter and the end of 2001 might be made (possibly with waivers or under somewhat revised performance criteria). Perseverance by the Fund in this charade clearly did not encourage the Argentine authorities to face up to the reality of their situation and to the painful but necessary decisions implied by this reality.

Damage was also done to the Fund and to its usefulness to the international community. Although much skepticism has been voiced in recent years, I believe that experience clearly demonstrates that there are important situations where large official support packages can be useful in containing the damage from international financial crises—without putting the public funds lent in such packages at substantial risk. This was so for Mexico in 1995, for South Korea in 1998, and for Brazil in 1999. (Thailand in 1997–98 is less clear, in my view; and Indonesia in 1997–98 and Russia in 1998 were clearly not successes.) However, even most advocates of the occasional use of large official support packages recognize that there must be limits, both on their size and on the circumstances where they are appropriate. Otherwise, problems of moral hazard could potentially become quite serious, and the official community could run the danger of assuming risks from private creditors that should not be transferred to the general public.

The Fund, and the power structure through which its decisions are made and approved, is the instrument through which the international community determines the conditions and circumstances in which large official support packages will, and will not, be provided. If the Fund fails to act (or not act) in a responsible manner—in accord with the principles and practices that, it is generally agreed, should govern its behavior—then the interests of the international community will not be properly served. In the end, if the Fund fails to do its job properly, its resources and its role as a valuable instrument of the international community will surely diminish. The Fund's performance in the case of Argentina during the summer and autumn of 2001 surely added to concerns in this regard.

Institute for International Economics | http://www.iie.com

Collapse

The late Herbert Stein was fond of observing that something which is unsustainable will not last. Even as the Fund's August augmentation was arriving (in early September 2001), the tragic end of Argentina's efforts to avoid default and preserve the Convertibility Plan was drawing near. Parliamentary and provincial elections in mid-October turned control of the national legislature and of most provincial governorships over to the opposition Peronists. That meant even less political support for austerity measures needed to implement Cavallo's zero-deficit policy at the central-government level. Negotiations with provincial governors for their necessary contribution to greater fiscal austerity bogged down. Tax revenues dwindled as economic activity continued to shrink and tax avoidance and evasion (always a favorite sport in Argentina) escalated, encouraged by the government's increasing dereliction of its own payments obligations. In world financial markets, the value of Argentine sovereign bonds plummeted further, with spreads over US Treasuries rising above 2,000 basis points.

Driven to the wall, Minister Cavallo announced that Argentina would have to approach its creditors to request a debt rescheduling that would substantially reduce debt-service requirements. The rescheduling was portrayed as entirely voluntary and market friendly, but clearly it would be neither. Domestic holders of Argentine government debt, primarily banks and pension funds, were approached first, and they were strong-armed into accepting new claims with lower interest rates and longer maturities. External creditors were told that they would be next, after the legal basis for the zero-deficit plan had been put in place. Debt service on external credits was maintained, however, to avoid a legally declared default.

By mid-November, the cash position of the government was again becoming precarious. Withdrawals of bank deposits and losses of foreign exchange reserves again began to accelerate. Minister Cavallo announced that he was prepared to travel to Washington to speak to the Fund about further disbursements. He was informed, rather chillily, by the Fund's new first deputy managing director that he would not be received. Learning from the debacle of August, world political leaders offered muted expressions of sympathy, but no suggestions of increased financial support. Chutzpah had worked once, but not twice. Nevertheless, a Fund mission continued to negotiate with the Argentine authorities over additional fiscal measures that might (if one believes in miracles) somehow make the zero-deficit objective seem achievable and justify continued Fund disbursements. Even at this late stage, the Fund apparently lacked the courage to tell the Argentine authorities forthrightly that the program was irredeemably off track and that very different and difficult policy alternatives needed to be considered.

Institute for International Economics | http://www.iie.com

In the last week of November, the run on Argentine banks escalated, reaching nearly $1 billion a day. With foreign exchange reserves down to $15 billion (barely enough to cover domestic currency in circulation), the end had come. The government was forced to close the banks and announce that when they reopened, cash withdrawals would be limited to $250 a week. This was described as a temporary measure, for up to three months; but Argentines generally realized the truth. The Convertibility Plan was finished. The banks were bust. Depositors would be lucky if they ultimately got anything near the book value of their claims. In the streets of Buenos Aires, pesos were exchanged for dollars at a discount of about 25 percent; across the Rio de la Plata in Montevideo, the discount was about 50 percent.

After more than three years of recession, with unemployment at nearly 20 percent and rising, deprived of access to their bank deposits, and with the value of the domestic currency rapidly depreciating in the black market, the Argentine people had finally had enough. Riots in the provinces spread to the capital. Stores were looted. Banks were ransacked. Foreign-owned businesses were attacked. In efforts to restore order, nearly 30 people died. Recognizing that his efforts had failed, Minister Cavallo resigned, and President de la Rua soon followed.

It is sad, most of all for Argentina, that a decade of stabilization and reform ended so tragically. It need not have been so. Even when sovereign default clearly became inevitable by the summer of 2001, a less catastrophic outcome might still have been managed. This would have required recognition of the need to seek a restructuring of Argentina's sovereign debt and a reasonable plan to deal with the consequences for the domestic financial system and for the viability of the Convertibility Plan. Prior consultation with the Fund and prearranged financial support to help contain the substantial disruption from debt restructuring and a likely break in the Convertibility Plan could have proved quite valuable—even though, with the best possible planning, management, and support, it still would have been a messy affair.

It is impossible to know at what point sovereign default and a likely collapse of the Convertibility Plan became unavoidable. Perhaps it was already too late by the autumn of 2000. But surely, the ultimate tragic collapse was not preordained from the time that Argentina's stabilization and reform efforts began a decade earlier. The Convertibility Plan clearly implied a very rigid framework for Argentina's exchange rate and monetary policy. This limited the options available to respond to adverse shocks, such as those associated with Brazil's exit from its exchange-rate-based stabilization effort. It also meant that if developments ever did lead to a collapse of the Convertibility Plan, the consequences for the financial system and the Argentine economy were likely to be significantly more catastrophic than with a less rigid exchange rate and monetary policy regime.

Institute for International Economics | http://www.iie.com

However, the fundamental cause of Argentina's tragedy was not primarily the Convertibility Plan. Rather, it was the large and persistent excess of public spending over recurring revenues that led to an unsustainable accumulation of public debt and ultimately to sovereign default that fatally undermined the basis for Argentina's financial and economic stability—and would have done so under virtually any conceivable monetary policy and exchange rate regime.

Of course, the long recession that began in late 1998 made containment of Argentina's fiscal deficit and buildup of sovereign debt more difficult—both economically and politically. But, as was emphasized above, the fiscal problem started much earlier. If during each year of the past decade the primary balance of the entire Argentine government had been, on average, 2 percent of GDP better, the cumulative effect (including reduced interest expense) would have lowered Argentine sovereign debt in 2001 by about $60 billion. This would have removed any serious concerns about sovereign default and would have allowed significantly lower interest rates and a much better environment for economic recovery. Indeed, even moderately vigorous and realistic efforts of fiscal consolidation beginning with the recovery from the tequila crisis probably would have done the job. For example, an improvement in the primary balance of 1 percent of GDP in 1996, 2 percent of GDP in 1997, and 3 percent of GDP in 1998 should have been economically and politically feasible during these rapid-growth years; and holding on to an established fiscal improvement of 3 percent of GDP should have been achievable in the more difficult period of 1999–2001. This improvement in fiscal policy would have reduced Argentine debt in 2001 by about $40 billion (below the actual level), and it would have provided a convincing demonstration over six years of a capacity to run a more responsible fiscal policy. This should have been enough to remove serious doubts about fiscal sustainability. Thus, the margin between sustained success of Argentina's stabilization and reform efforts of the past decade and the tragic collapse at the end of 2001 was far from insurmountable.

Indeed, the tragedy in Argentina is epic not because, as in most Greek tragedies, it was inevitable, but because it was avoidable. After decades of generally poor economic performance and high inflation, punctuated by financial crises, the reforms of Carlos Menem and Domingo Cavallo delivered a sustained period of financial stability and economic progress. Inflation was banished. Despite the recession of 1995, for eight years, economic activity advanced at the highest average pace in a half-century. Trade was significantly liberalized. Inefficient public enterprises were privatized and compelled to become much more efficient. The banking system was put on a sound footing. A private pension system was established. The development of domestic capital markets was encouraged. And, as was proudly emphasized by President Menem in his address to

Institute for International Economics | http://www.iie.com

the IMF-World Bank Annual Meetings in October 1998, the benefits of reform spread broadly: the number of Argentines living below the poverty line declined from 38 percent in 1989 to 18 percent; infant mortality fell by 27 percent; and 100 percent of children of school age attended primary school.

Thus reform accomplished a great deal—and promised to deliver more. But the fundamental failure to address adequately Argentina's persistent fiscal weakness—to a degree that was or should have been economically and politically feasible—ultimately undermined all of this progress and promise. Now, with sovereign default, with the collapse of the Convertibility Plan, with the failure of the financial system, and with the decline in the respect for law and rise in general distrust of government, Argentina faces its gravest economic crisis in at least a half-century: a true tragedy.

Institute for International Economics | http://www.iie.com