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Lessons for the Fund

If the International Monetary Fund is to recover and improve as a useful instrument of the international community, it must learn from the experience of its involvement with Argentina during the past decade. Such learning must begin with the recognition that though the tragic failure of Argentina's initially successful efforts at economic stabilization was primarily the consequence of what Argentina did and did not do, it also reflects important mistakes by the Fund. If these mistakes were isolated errors, their significance for the Fund's general operations would be limited. However, there has been a great deal of criticism of the Fund across a wide range of its operations during the past decade. Though much of this criticism, in my opinion, has been misinformed, misguided, and in some cases mean-spirited, the mistakes that the Fund made in Argentina are not isolated errors. Rather, they reflect wider deficiencies that merit careful diagnosis and serious efforts to find remedies.

Tough Cop or Sympathetic Social Worker?

To understand why the Fund made important mistakes in Argentina and limit the future risk of similar mistakes, it is essential to recognize the fundamental tension between two key roles that the Fund is expected to play in the international economic system. The Fund is expected to serve the interests of its members, individually and collectively, by acting both as a sympathetic social worker and as a tough cop. As a sympathetic social worker, the Fund provides friendly advice to its members about their economic policies and provides financial assistance in times of actual or po-

tential difficulties. The advice must, of course, take note of policy deficiencies, but it should be cognizant both of the political difficulties of implementing necessary but unpopular measures and of the political and financial market sensitivity of any public criticism. To be most effective in reassuring financial markets at times of actual or potential crisis, the Fund's financial support should be available in large amounts, with sympathetic understanding of situations when policy measures fall somewhat short of their objectives, and without much emphasis on the possibility of interruptions in assistance if Fund-supported programs go seriously off track.

On the other hand, as the tough cop of the international financial system, the Fund is expected to point out explicitly (and in the new age of transparency, also publicly) key deficiencies in the economic policies of its members. Its financial assistance to members is supposed to be limited to the "catalytic role" of filling in modest financing gaps that might remain after account is taken of the effect of a member's adjustment program in restoring market confidence. For this purpose, Fund financial support should be tightly conditioned on a rigorous program of adjustment measures, with vigorous actions required to correct any deficiencies in meeting program objectives.

Much of the popular discontent with the Fund, especially in countries that have operated under Fund-supported programs, is that the Fund is overzealous in its role as a tough cop, rather than overindulgent in its role as a sympathetic social worker. In fact, the reverse is far more often the case—as a moment's reflection on the nature of the Fund should reveal.

The Fund exists to serve its members. In their individual interactions with the Fund, virtually all members prefer to deal with the sympathetic social worker rather than the tough cop. Even industrial countries that no longer expect to make much use of financial support from the Fund do not usually appreciate criticism, especially public criticism, of their policies. Developing countries that do or might make use of Fund resources are generally even less enthusiastic about the Fund as a tough cop—as applied to them individually. Applied to others, of course, members see important virtues in an effective policeman. Even users of Fund resources must recognize that if the conditionality associated with Fund support is seen as a travesty, its value in helping to restore confidence will be seriously undermined. Nevertheless, the preference of countries about how they would like to be treated individually as members of the Fund undoubtedly holds sway.

It is not surprising that the preferences of members affect how the Fund operates. Inevitably, the incentives for the Fund staff and management and most individual members of the Executive Board (although not usually the Executive Board as a collective) are to lean sympathetically toward the preferences of members. This tendency is not absolute. The Fund does criticize members' policies, often quite forcefully and some-

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times in public. Fund financial support is usually provided in moderate amounts and is subject to relevant conditionality. It is not unusual for disbursements under established Fund programs to be interrupted, sometimes for brief periods and sometimes for extended periods, when programs go off track.

But the tendency in the Fund is to give the benefit of the doubt, sometimes the overwhelming benefit of the doubt, to the member. And because this tendency is the consequence of the preferences of the membership and the incentives to serve those preferences, it persists despite the generally high level of professional competence and dedication of the Fund's staff and management and its executive directors.

This tendency was clearly apparent in the case of Argentina. Initial doubts about the desirability and viability of the Convertibility Plan were suppressed after it passed the crucial test of the tequila crisis, notwithstanding the longer-term difficulties and risks that this arrangement might pose for the Argentine economy. This was plausibly justified under the important principle that it is the right of a member to determine its own exchange rate and monetary policy regime. This excuse, however, does not apply to what I have argued to be the Fund's inadequate attention to the failures of Argentine fiscal policy. Indeed, the rigid constraints of the Convertibility Plan clearly made a potentially unsustainable fiscal policy an even greater danger for Argentina. Accordingly, this should have intensified the Fund's critical focus on the failures of Argentina's fiscal policy.

Improving the Fund's Accountability and Performance

How might the Fund's performance in such situations be improved? In my view, something is clearly needed to counterbalance the tendency of the Fund to act too much as a sympathetic social worker—without going too far in the other direction. Specifically, there need to be better mechanisms of decision making and of accountability in the Fund: mechanisms that provide more effective checks and balances to assure that decisions are made on the basis of the best possible analysis, not analysis that is biased by a desire to see things from the member's point of view; and mechanisms that provide for careful appraisal of the Fund's performance in critical cases and, when mistakes have been made, appropriately assess (in some detail) the responsibility for those mistakes.

One possibility would be to alter the Fund's internal practices and bureaucratic organization to give less of a bias toward positive assessments of members' economic performance and policies. The Fund's area departments are responsible for maintaining its key relations with its members and for preparing the documents for its surveillance and programs. This

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has been an efficient arrangement which has contributed importantly to the Fund's effectiveness as an international organization.

However, by the nature of their responsibilities and because of their need and desire to maintain close cooperative relations with the authorities of member countries, the bias toward the member tends to be particularly strong in the Fund's area departments. Other departments that review and comment on the work of the area departments should counterbalance their natural bias. But because the area departments control the word processor in drafting key documents, the counterbalancing effect tends to be muted. The Fund's management is supposed to settle differences among the staff; and it approves all key documents. However, in my experience, management normally sides with the area departments in their efforts to be as cooperative with members as possible.

The Executive Board is rarely informed of differences in views among the staff; it only sees the finally approved documents and hears (on country matters) the staff of the area departments. Thus, although the Executive Board has different interests and incentives as a collective entity than those of individual executive directors in trying to serve the specific interests of the individual members that they represent, its role as a counterbalance to the bias to see things from the individual member's short-term perspective is also compromised.

Accordingly, a change in these procedures that allowed for a more fully informed Executive Board—one better able to perceive the biases in the work of the staff and management—might imply a somewhat greater incentive for management to insist on a balanced view and to value constructive dissent in the work of the staff. This, in turn, would tend to diminish the bias of the Fund toward seeing things in the best possible light from the perspective of the member.

Another important means of improving accountability is to make good use of the Fund's independent evaluation office, which has just started to operate. Because it functions under the authority of the Fund's Executive Board, independent of staff and management, this office should be relatively free of the natural human tendency of those most directly responsible for the Fund's operations to see their own work as largely error free and not subject to any undesirable biases. However, as an agency within the broader institutional framework of the Fund and ultimately responsible to the Fund's membership, the effective independence and integrity of the evaluation office remain to be demonstrated.

Clearly, analysis and assessment of the Fund's performance in Argentina will be a key challenge for the new evaluation office. It is to be hoped that it will choose to undertake this challenge within the next year or so and make its report promptly and publicly available. Quite possibly, such an evaluation will not agree entirely with what is said in this policy analysis. However, it seems highly implausible that an honest and rigorous appraisal could conclude that the Fund made no serious mistakes in its in-

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volvement with Argentina during the past decade. Because the deterioration of Argentina's public finances ultimately led to the largest sovereign default in history, and because this default plays an important role in Argentina's other miseries, surely a careful appraisal of the Fund's efforts to influence Argentina's fiscal policy appears essential. Other issues, including the Fund's analysis and advice concerning Argentina's Convertibility Plan, also deserve to be on the agenda.

Indeed, a comprehensive assessment of Fund's work on all significant issues in the Argentine case is important to avoid drawing the wrong conclusions. For example, it is my view that the Argentine government's basic decision to combine efforts at macroeconomic stabilization with market-oriented reforms that reversed decades of interventionist policies and protectionism was the right policy approach, and that the Fund was right to support this approach.

In accord with this view, the spectacular success of the Argentine economy throughout most of the past decade is attributable to this basic policy choice; and the spectacular collapse in 2001 is due to the failure to implement this strategy sufficiently vigorously, especially in the area of achieving and maintaining adequate fiscal discipline. Others, however, may be inclined to the view that the policies of the so-called Washington consensus are fundamentally wrong and were doomed from the start to produce a disaster in Argentina. An evaluation of the Fund's role in Argentina should reflect on this broad question.

Issues concerning Argentina's fiscal, monetary, and exchange rate policies lie at the heart of the Fund's typical concerns with its member's macroeconomic policies, and the appraisal of the Fund's work on these issues concerns primarily the work of the relevant staff and effectiveness of the supervision provided by management. As was emphasized in chapter 1, the Argentine case is particularly noteworthy, relative to most other cases where the Fund has provided exceptionally large financial support, in the extent to which the key policy concerns were those that lie at the heart of the Fund's traditional responsibilities and expertise. Accordingly, a carefully critical evaluation of the performance of the Fund's staff and management in this case is potentially of considerable significance for a more general assessment of how the Fund does its assigned job and what may be needed to improve its performance in its central areas of responsibility.

Another key issue in the Argentine case is the appropriateness of the decision to provide exceptionally large Fund support to Argentina that was made in December 2000 (and approved by the Executive Board in January 2001) and of the decision to significantly augment that support made in August 2001 (and approved by the Executive Board in September 2001). Here the main responsibility rests with Fund management and with key officials in leading Fund members who were actively involved in making or approving these decisions. No report on the Fund's involve-

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ment in Argentina would be complete or credible without forthright discussion of these issues.

The Role of Large Support Packages

Beyond an appraisal of whether large-scale assistance to Argentina was appropriate in the particular circumstances of that case, there are also some important implications for the general policy issues associated with large-scale financial assistance packages. In my view, one useful suggestion is to require that the Fund (staff and management) prepare a special, formal justification for any proposal to extend support to a member beyond the normal limits of access to Fund resources (100 percent of Fund quota in any single year, and a cumulative maximum of 300 percent of quota).

In connection with this justification, it would also be useful to indicate (to the Executive Board, but not publicly) expectations concerning substantial policy adjustments that the member might be required to undertake if a program backed by exceptionally large Fund support began to go seriously off track. For example, in connection with the large support package of December 2000/January 2001, the Argentine authorities should have been told explicitly (but privately) that if the program backed by this support package went seriously off track (as it clearly did by the summer of 2001), then a compulsory restructuring of Argentina's sovereign debt and possibly a substantial alteration in the Convertibility Plan would need to be implemented.

Under the Fund's established policies, support beyond the normal limits of access is supposed to occur only in "exceptional circumstances." What constitutes exceptional circumstances has never been defined; and, in my view, it would be a mistake to try to define this term in a general way and then apply it to individual cases. In individual cases, however, it should be possible to say explicitly what makes them exceptional enough to justify Fund support beyond the normal limits. It would be appropriate within the Fund's usual procedures to require that the Fund staff and management make this justification explicit to the Fund's Executive Board.

I would also suggest that all cases of exceptional access should be reviewed, ex post, by the independent evaluation office—both concerning their general features and consequences and with respect to the justification for exceptional access. Suggestions that super-majority votes of the Executive Board should be required to approve programs with exceptional access, however, do not appear to be either useful or appropriate. In fact, decisions by the Executive Board on Fund programs are taken by consensus; and there are few instances where any executive director votes no on a program recommended by management (although executive directors do sometimes exercise considerable influence on Fund programs before they are submitted for formal approval).

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Since the large support package arranged for Mexico in 1995, these operations have been the subject of a great deal of comment and criticism. The key concern has been that a policy of providing such packages to countries facing external financing crises tends to generate moral hazard that may make such crises more likely. Specifically, expectations of the large-scale official support may encourage either countries or their creditors to undertake imprudent risks because they expect that, in the event of crisis, the international community will step in and shield them from an important part of the losses they would otherwise have to absorb.

To deal with this perceived problem, a number of proposals have been advanced to eliminate or curtail large-scale support packages or to structure them in ways that would better control problems of moral hazard. These proposals cover a wide range—including abolition of the Fund; replacement of traditional Fund lending to countries in difficulty with prequalified credit extended only to countries with outstanding economic policies; and limitation of Fund support to the normal level of 100 percent of Fund quota, with the requirement that amounts above this limit be conditioned on a restructuring of a country's external debt.

In particular, the Report of the International Financial Institutions Advisory Commission, generally know as the Meltzer Commission report was generally quite critical of the Fund's operations in recent financial crises. The commission's majority recommended scrapping the Fund's traditional approach of providing support. Specifically, in contrast with current practice, the Fund would not provide support to countries in crisis or facing an immediate threat of crisis, subject to conditionality on policies to address that actual or potential crisis. Instead, to encourage countries to have good policies that would effectively avoid potential crises, the Fund should be prepared to pre-commit large packages of support to those countries judged to have outstanding economic policies. (Almost by definition, such countries would not face crises at the time that Fund support was initially committed, although they might later face the threat of contagion from countries that did not have outstanding policies.) Policies to create and maintain a sound domestic banking and financial system, including liberal rules for participation of foreign banks, were given special importance. In contrast, the need for a sound fiscal policy was only added as an afterthought to the commission's majority view.

On the criterion of having a sound banking system, with widespread participation of foreign banks, Argentina was clearly outstanding (ignoring what might happen in the event of sovereign default or collapse of the Convertibility Plan), and it was particularly praised in this regard by one of the members of the Meltzer Commission's majority. Presumably, on these grounds, under the commission's proposals, Argentina would have qualified for a very large package of pre-committed support.

If most of what has been argued in this book is mainly correct, however, it clearly would have been a serious mistake to pre-commit a huge pack-

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age of support for Argentina primarily on the basis of its sound banking system—and effectively ignore the risks of sovereign default and collapse of the Convertibility Plan implicit in an inadequately disciplined fiscal policy. Moreover, if the Meltzer Commission proposals were now applied to Argentina, with its wrecked banking system and collapsing economy, the implication would presumably be that no substantial Fund support should be committed to Argentina, regardless of the policies of the Argentine government, until a sound banking system is restored—which can probably only occur after the present deep crisis is largely resolved.

More generally, in my view, concerns about moral hazard have been vastly exaggerated, and most of the proposals to deal with this purported problem (including those of the Meltzer Commission) are unnecessary, unworkable, or fundamentally misguided. The Argentine case is particularly relevant in this regard. When a country experiences a financial crisis, it typically suffers very substantial economic damage. International financial support should help to ameliorate that damage; but it is absurd to think that expectations of such support are an important inducement for countries to run the risk of such crises.

Indeed, in the case of Argentina, the key policy decisions that created the risk of a catastrophic crisis were the decisions to adopt and maintain the Convertibility Plan and the cumulative decisions that led to an unsustainable fiscal policy even when the Argentine economy was performing well. These decisions were made well before there was any question of large-scale financial support from the Fund, and it is implausible to suggest that they were meaningfully influenced by expectations of such support.

Most foreign investors also suffer substantial economic damage when a country experiences an external financing crisis. This includes most owners of direct investments and portfolio equity investments, as well as holders of longer-term bonds that sell out when market values decline sharply during a crisis. However, some foreign investors are usually able to escape large losses when there is a crisis, and they are aided in doing so by the availability of official financial support. Specifically, holders of short-term credits (especially interbank credits) are often able to get out without large losses, and owners of longer-term credits (especially of sovereign credits) may come out whole if they hold their positions and default is ultimately avoided.

So what? In private capital markets in industrial economies such as the United States, when a business firm gets into financial difficulty, many short-term creditors are often able to get out without significant loss. Indeed, businesses frequently arrange secondary lines of credit to help finance an exit of their normal suppliers of short-term credit if the suppliers of such credit become nervous. Also, when businesses need to restructure their finances without the firm actually going insolvent, bondholders often do quite well, while the claims of equity owners are seriously di-

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luted or even wiped out. Thus, efficient functioning of advanced capital markets and containment of moral hazard do not require that, when a borrower experiences difficulties, all of the claimants on a business' capital suffer losses or that such losses be similar across different types of claimants. Of course, when a firm is deeply insolvent, all claimants on its capital (except those that have already gotten out or hold claims secured by specific assets) may expect to suffer substantial losses—although generally not in the same proportion.

Presumably, international capital markets should function in a similar manner. Argentina is a particularly noteworthy case in this regard. Substantial official support was committed to Argentina in December 2000–January 2001 in an effort to give the Argentine authorities one last chance to demonstrate fiscal prudence, restore market confidence, and avoid catastrophe. Even with the unwise augmentation of official support in August/September 2001, however, the level of official support clearly remained well below that which would provide an effective bailout for the bulk of Argentina's private creditors.

Indeed, the Argentine sovereign did ultimately default on a large volume of private credit. And, as one would want and expect in an efficiently functioning capital market, virtually all investors in Argentina (except those who got out early) will have to absorb very large losses. This includes holders of short-term credits and holders of sovereign bonds that, in many financial crises, escape with comparatively modest losses.

Were there not, at least occasionally, a case like Argentina, private investors might conclude that there was virtually no risk from investing in sovereign bonds of emerging-market countries. But a case like Argentina, and Russia before it, teaches a powerful lesson that even politically important emerging-market countries do sometimes default on their sovereign bonds. Indeed, while global financial markets reacted with shock and surprise to Russia's default in August 1998 because it was widely believed that Russia was "too nuclear" to be allowed to fail, the general financial market reaction to Argentina's default has been quite muted. Apparently, markets do understand that there are significant risks in investing in emerging markets, including in sovereign credits; and they recognize that these risks will sometimes materialize in substantial losses.

To be clear, it would not have been appropriate to limit international support for Argentina to provoke a sovereign default because that was useful or necessary to send a message to private capital markets. If the policy efforts of the Argentine authorities supported by the financial package of December 2000/January 2001 had succeeded in containing the fiscal deficit, restoring financial market confidence, and avoiding a sovereign default and a collapse of the Convertibility Plan, that clearly would have been a much better outcome. But, given that a catastrophic crisis proved unavoidable, it is right to take note of the lessons that such a crisis teaches about market discipline.

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Moreover, Argentina is not the first, and is unlikely to be the last, emerging-market borrower to be forced into sovereign default and an associated deep economic and financial crisis. Although not usually as great as in the case of Argentina, the costs of such crises are typically huge. It is difficult to believe that we need to encourage more such crises than we are otherwise likely to see to keep within acceptable bounds the problems of moral hazard likely to arise from international support provided by the Fund and other international financial institutions.

Finally, it should be emphasized that if exceptional support from the Fund and the international community is to play its appropriate role in limiting the risk of and damage from potential and actual financial crises, it must be used with competent discretion. Sometimes, as in the large-scale assistance provided to Mexico by the Fund and the US Treasury during the tequila crisis, such assistance will succeed in supporting the determined efforts of the national policy authorities to avoid an unnecessarily disastrous crisis, as would have followed in the wake of a Mexican sovereign default.

In other cases, such as South Korea during the Asian crisis, large-scale official assistance may be effectively and efficiently combined with constructive actions to enlist private-sector creditors to support credible policy efforts to contain and reverse a financial crisis. In yet other cases, such as (arguably) Argentina in late 2000, it may be worth the risk to commit large-scale official assistance to support efforts to avoid a disastrous outcome, even if it later turns out that those efforts fall short. But there will also be cases, such as Russia in August 1998 and Argentina by the summer of 2001, where there is no realistic hope of sufficiently determined policy actions that will rescue a desperate situation; in such cases, provision of large-scale official assistance is a mistake. The task of the Fund, on behalf of the international community, is to exercise competent discretion in distinguishing between these situations and acting appropriately.

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