

ARGENTINA AND THE IMF: *LEARNING LESSONS FROM OUR EXPERIENCE*

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Abstract

The Fund has already produced an evaluation of the lessons that could be drawn from the crisis in Argentina.² That assessment mainly dealt with Argentina's authorities' errors that lead to the crisis and, to some extent, also with the role that the Fund played in supporting those policy failures.

This paper analyses Argentina's experience in dealing with the Fund during the aftermath of the crisis³ and draws some lessons on what changes could be introduced into two of the most critical policies of the Fund, i.e. conditionality (on both, structural and macroeconomic objectives) and its role in dealing with full-blown debt crisis.

The first section of this paper analyzes whether the structural reforms included in the two arrangements signed with the country after 2002 were strictly critical to the achievement of Argentina's macroeconomic objectives and foremost, regarding its debt sustainability. We conclude that some of the structural conditionality was unnecessary and that when the required reforms are beyond the reach of the government's executive branch, performance criteria could actually backfire.

¹ I have benefited greatly from discussions and comments provided by Roberto Lavagna, Guillermo Nielsen and Pedro Lacoste. I am particularly thankful to José Costa and Cecilia Todesca Bocco for their insightful suggestions. This article, however, expresses only my own personal views. The author is Executive Director at the IMF for the Southern Cone countries.

² See Independent Evaluation Office (IEO), "Report on the Evaluation of the Role of the IMF in Argentina 1991-2001", July 2004. Available at: <http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm>.

³ The paper was drafted in September 2005.

In the second section we look into Argentina's experience on macroeconomic conditionality trying to explore whether it is sensible to pursue a one-size-fits-all primary surplus criterion. We conclude that it was not appropriate to press Argentina to achieve similar fiscal surpluses as those included in arrangements with countries like Turkey or Brazil, since the underling comparisons were not tenable.

The third section considers Argentina's experience in dealing with the "Lending into arrears" policy and particularly whether the Fund, in conditioning its new lending to demonstrations of "good faith", is consistently avoiding the moral hazard that stems from bailing out private creditors. We conclude that the Fund seems to be still undecided on what role (if any) it should play when a sovereign is in financial distress and needs to restructure its debt with private creditors. We also conclude that using the Fund's financial leverage to impose ambitious fiscal surpluses and conditioning new lending to improvements in the debt restructuring offer could be as morally hazardous as bailing-out private creditors.

In short, using Argentina's experience as a model, the paper draws some lessons and proposes changes in the Fund's approach to conditionality and to its role in full-blown debt crisis. We think that it is particularly timely to take stock of these lessons since the Fund has just launched a review of the Fund's Medium Term Strategy and both, conditionality and the "lending into arrears" policy are issues of the utmost importance for developing countries.

SECTION I

CONDITIONALITY ON STRUCTURAL REFORMS: Should the Fund limit them to the strictly indispensable?

It is a common understanding that the Fund should focus on macroeconomic objectives usually regarded as the core areas of IMF's responsibility (i.e. monetary, fiscal and exchange rate policies as well as financial sector issues). However, the identification and inclusion of structural conditionality in arrangements with member countries is justified when it is instrumental to the achievement of the aforementioned macroeconomic objectives.

The Fund should, consequently, exercise restraint in using its financial leverage to impose structural conditionality as "performance criteria"⁴ in arrangements with borrowing countries. In our view this could be boiled down into three principles:

- be as less intrusive as possible (ownership of reforms is compromised when citizens see them as resulting from external pressures);
- limit conditionality on structural reforms to the strictly indispensable (those that truly compromise macroeconomic results)⁵ and;

⁴ "Performance Criteria" are mandatory targets, i.e. variables or measures whose observance or implementation is established as a formal condition for the making of purchases or disbursements under a Fund arrangement. Performance criteria should be applied to clearly-specified variables or measures that can be objectively monitored by the staff and are so critical for the achievement of the program goals or monitoring implementation that purchases or disbursements under the arrangement should be interrupted in cases of nonobservance (based on "Selected Decisions and Selected Documents of the International Monetary Fund", Twenty-Eight Issue, December 31, 2003, Use of Fund Resources, page 238).

⁵ According to "Guidance on the Design and Implementation of IMF Conditionality, June 3, 2002" instruments such as prior actions or performance criteria are "to be used *sparingly* and should be focused on those measures that are necessary for the achievement of the macroeconomic goals of the program and to safeguard Fund resources." (emphasis added). Unfortunately, as we will discuss further, this is far from being the practice.

- always give governments flexibility in implementing structural reforms (cornering governments with fixed or very ambitious deadlines creates fatigue and may play into the hands of those opposing reforms, particularly in the cases where the executive branch of a government needs the support of the congress to implement them).

Using Argentina's experience to illustrate these points we can quote two examples of misplaced structural reform:

- 1) In 2002 the staff insisted in getting the Congress to overturn a law that had been enacted by the last military dictatorship (i.e. the "Economic Subversion Law"). Admittedly this law gave leeway to the executive branch of the government to prosecute almost any economic activity by adducing that it was "subverting" order (imposed by the military junta). It was an awful piece of legislation that had never been applied by any democratic government and that Mr. Duhalde's government⁶ had no intention of applying. Nevertheless during the financial, economic and social turmoil that followed the abandonment of the Currency Board ("*Convertibilidad*") and the declaration of default in January 2002, some voices were raised in Argentina on the need to punish those considered "responsible" for the capital flight that preceded the debacle. In this context, the aforementioned "Economic Subversion Law" appeared as giving the necessary legal basis to those isolated attempts. The law was finally overturned, but at a great political cost for a government that had to withstand accusations of sheltering those that had benefited from capital flight from the country. Naturally,

⁶ Mr. Eduardo Duhalde was Argentina's President between January 1, 2002 and May 25, 2003. He was elected by Congress at the climax of the crisis and after the resignation of President De la Rúa and three other ephemeral successors.

the government had several other more sensible priorities on which to spend its very scarce “political capital” more worthily.⁷

- 2) Moving to a more recent experience. In the stand-by arrangement approved in September 2003, the Fund staff insisted in including structural conditionality (as a “structural performance criterion”) on the approval of a new fiscal revenue sharing system. This required Congress to pass a new “Co-participation Law” to settle, on the basis of objective criteria⁸, the distribution of fiscal revenues amongst Argentina’s provinces and between the provinces as a whole on the one hand, and the federal government on the other. Fiscal revenue is currently shared on the basis of a knotty legal system that bundles many ad-hoc and old laws that result in a very intricate process. Needless to say, it is in Argentina’s long-term interest to replace this knotty system with a straightforward new revenue sharing arrangement that reflects objective criteria for distribution, rather than the over-representation⁹ of small provinces at the Senate. In fact, Argentina’s constitution itself requires—as a result of its last amendment—that such a new law should be enacted, so in this specific case there is no ownership problem regarding this particular structural reform. However, the approval of a new revenue-sharing law poses extremely difficult political challenges. Although applying “objective criteria” to distribute scarce fiscal revenue is desirable, such a change would benefit the more populated provinces at the expense of smaller provinces. Naturally, smaller provinces—and Senators representing them—oppose such a

⁷ Incidentally this was presented as a sort of prior action on the part of the Fund to enter into formal discussions with Argentina on an economic program to be supported by the Fund. The prior action was met but, nevertheless, the year 2002 passed by and Argentina was unable to get the desired support during this most critical time of its economic history, despite the fact that the key macroeconomic indicators were already pointing in the right direction.

⁸ “Argentina—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding”, September 10, 2003, page 10, paragraph 31. Available at: <http://www.imf.org/External/NP/LOI/2003/arg/03/index.htm>.

⁹ According to Argentina’s constitution each province is represented by three senators, regardless of its number of inhabitants (Article 54 of the Argentine Constitution).

reform. As a consequence, to comply with the Fund's conditionality the federal government should itself reduce its participation in fiscal revenue. Needless to say, this would compromise its capacity to generate the ambitious primary surplus required to serve the country's public debt. There were several attempts to pass a new co-participation law but all failed because it proved to be impossible to find a balance between the "entitlement" of Buenos Aires province (by far the most populated) for a bigger chunk of fiscal revenue and the capacity of senators representing small provinces to block such a reform. The current government managed to ensure fiscal discipline in provincial governments (provinces are generating record fiscal surpluses after more than a decade in the red)¹⁰ and would have been more than happy to have such a law approved by Congress. However as it was publicly known that the Fund was conditioning its financial support to the approval of such a piece of legislation, provinces felt that they had gained leverage in the negotiations with the federal government.¹¹ In short, the Fund's requirement backfired¹² by creating a sort of "political rent" that played into the hands of provinces indebted to the federal government. Rather than helping the federal government to rein in provincial expenditures (as the government was, indeed, doing) it benefited those opposing reform.

Thus, the lesson that we can draw from Argentina's experience is that when a Fund program imposes structural conditionality that requires action that is beyond the reach of the executive branch of government (e.g. requiring specific action by congresses,

¹⁰ Since 2003, the Government has accomplished primary fiscal surpluses (at the National Public Sector, i.e., including provinces) well above 3% of GDP.

¹¹ During the crisis, several provinces issued provincial bonds that were circulating together with the peso in Argentina's territory. The federal government withdrew these cuasi-money and the provinces remain indebted to the federal government.

¹² The government suspended the pursuance of this performance criterion when it came to the conclusion that achieving it attempted against its decision to put together an ambitious primary surplus

provinces or courts) the end-result may be at odds with the initially intended effect. At the same time, the Fund should restrain from requiring structural reforms that do not truly compromise macroeconomic results, avoiding both the waste of the government's political capital and reform fatigue.

SECTION II

PRIMARY FISCAL SURPLUSES: IS THERE A ONE-SIZE-FITS-ALL PRIMARY SURPLUS CRITERION OR SHOULD ARRANGEMENTS WITH THE FUND SET FISCAL PRIMARY SURPLUS CRITERIA ON A CASE-BY-CASE BASIS?

In this point let us start by referring directly to Argentina's experience. Some at the Fund argued that Argentina's target of a 3 percent of fiscal surplus was too modest and supported their position by comparing Argentina's surplus with Brazil's (4,25%) and Turkey's (6,5%). These comparisons have the attractiveness of simplicity, however, they are disingenuous.

- ✓ Due to the privatization program implemented in Argentina during the 90s (with the Fund's enthusiastic approval and IFIs support), Argentina's government has no public enterprises left and consequently no revenue additional to that of tax collection. Brazil and Turkey do have public enterprises and in both cases, these have made significant contributions to the fiscal surpluses obtained by their governments.
- ✓ Because of the 1994 reform to Argentina's social security system (reform that at the time was very much cheered by the Fund) the government has no net revenues coming from pension's contributions. Whereas this reform was aimed at reducing the governments medium and long term liabilities, in the short run, the government has, however, to continue providing pensions and other social security services to all pensioners that remain in the pay-as-you-go system and, also cover a Minimum Universal Benefit. In 2004, the corresponding fiscal transfers to the retirement and pension fund administrators [AFJP] amounted to 0.8 percent of GDP. This is not, fortunately, the situation neither in Brazil nor in Turkey.

- ✓ More importantly, it is necessary to recall that Argentina's social and economic context does not support the comparison. The Argentine crisis could not be contained and produced a widespread and sudden impoverishment of the population. Sudden impoverishment, unlike structural poverty, generates profound political resentment and social instability. The country was on the brink of generalized civil unrest. Unemployment peaked at 21.5 percent in May 2002. It now stands at 12.1% percent (and would be higher without government-supported employment program known as "*Jefes y Jefas de Hogar*"). Conversely, Brazil and Turkey could avoid the crisis, consequently their population was spared the sudden impoverishment experience, and their level of unemployment is substantially lower.

Last but not least, Argentina is the only one of the three main Fund's debtors that has not received any net financial support from the IFI's, nor from bilateral creditors, since late 2001. To the contrary, Argentina has protected the Fund's preferred creditor status, and in this context has made large net transfers to the IFIs (of over 13.5 billion US dollars) from the start of the crisis in January 2002 to August 2005, of which 7.7 billion were paid back to the IMF, reducing its debt with the Fund by more than 30% since the beginning of the Argentine crisis.¹³

¹³ Please find attached at the end of this document the net payments figures for Argentina to the IFIs as well as the net payments to the IMF from Argentina and other emerging markets.

SECTION III

“NO PUBLIC FUNDS USED TO BAIL OUT PRIVATE RISKS”. IS THIS REALLY WORKING?

We are all for avoiding the moral hazard stemming from the use of public funds to cover private risks or absorb private losses. However, in our opinion this “new paradigm” is not being applied consistently.

It is an incongruity to decide, on the one hand, that international financial institutions (IFIs) should not provide fresh financing to rescue a sovereign debtor in distress because this would imply “socializing” private risks whereas, on the other, telling the sovereign debtor that if it doesn’t show “good faith” in negotiations with private creditors by improving its offer, IFIs will cut-off all refinancing.

We need to agree on whether preventing or minimizing the consequences of a government default is a public good to be pursued. If in doing so the Fund would secure a public good, namely safeguarding financial stability and preventing a harsh adjustment that could negatively affect overall welfare, then it should be, in principle, legitimate to use public funds to rescue or assist the sovereign. Conversely, if the public good to be pursued is the avoidance of the moral hazard stemming from getting markets to believe that lending to sovereign debtors is risk-less because, ultimately, IFIs will act as lenders of last resort¹⁴(or twist the arm of the government forcing it to generate primary surpluses to pay back); then IFIs should stay clear from interfering in any way in the debt restructuring negotiations between a sovereign debtor and its private creditors.

¹⁴ Nouriel Roubini and Brad Setser depict two moral hazards, as IMF lending to manage debt crisis could be interpreted as a form of “insurance” that could “encourage reckless policies in emerging economies (debtor moral hazard) and reckless lending by creditors in industrial countries (creditor moral hazard)”, *Bailouts or Bail-ins? Responding to Financial Crises in Emerging Economies*, Institute for International Economics, Washington DC, August 2004, page 77.

As we will discuss below, current practice is, to say the least, ambiguous and may possibly imply an abusive use of political and financial leverage (albeit not public funds) in pursuance of private interests.

The Fund's "lending into arrears" (LIA) policy¹⁵ requires that sovereign debtors and private creditors should attempt, in good faith, to reach an agreement whose overarching objective should be to restore financial sustainability for the sovereign in distress. This implies that both parties must act in good faith. However, financial interests, unhappy with the Fund's hand-off policy, have been quite successful in lobbying some rich countries' governments and the Fund, arguing that "good faith" had to be demonstrated by the debtor during negotiations by its readiness to improve its payment offer.¹⁶

This is, in our view, inconsistent with the overarching objective of restoring financial sustainability and possibly also a breach by private creditors of their "good faith" obligation. Would an "agreement" between a developing country in financial distress

¹⁵ Main documents on the IMF's Lending into Arrears Policy are available at the IMF's website, mainly: "IMF Policy on Lending into Arrears to Private Creditors", prepared by the Policy Development and Review and Legal Departments, June 14, 1999, available at: <http://www.imf.org/external/pubs/ft/privcred/lending.pdf>; "Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion", prepared by the International Capital Markets, Policy Development and Review and Legal Departments, July 30, 2002, available at: <http://www.imf.org/external/pubs/ft/privcred/073002.htm>; Public Information Notice (PIN) No. 02/107, IMF Board Discusses the Good-Faith Criterion under the Fund Policy on Lending into Arrears to Private Creditors, September 24, 2002, available at: <http://www.imf.org/external/np/sec/pn/2002/pn02107.htm>.

¹⁶ This was repeatedly argued at the Board during discussions on Argentina. It is also worth noting that the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets", presented by the IIF (Institute of International Finance) in October 2004, require that, "as a sign of good faith", during the negotiations the debtor should resume partial debt service (to the extent feasible and full payment of principal and interest as conditions allow). It seems obvious to us that this is a unilateral "sign of good faith" as it does not require from creditors to resume financing during the negotiations. The final version of these principles is available at: http://www.iif.com/data/public/principles-final_0305.pdf.

and a politically backed private creditor lobby ensure a sustainable solution to the debt problem, as required by the Fund's LIA policy?

The result of a negotiation between unequally backed parties will tend to reflect their bargaining strength rather than medium term sustainability. Hence, an "agreement" in which a debtor faces a politically backed financial lobby that succeeded in conditioning the country's access to Fund's financial support to its capacity to "demonstrate good-faith", will most likely be financially unsustainable and eventually require additional net financing from the IFIs. Such a solution is certainly not in the overall interest of the international community.

This is not to say that securing a high level of acceptance by the private creditors for a debt-restructuring offer is not in the interest of the sovereign debtor in financial distress. However, debt sustainability is not assured by pleasing the private markets nor should their acceptance be taken as a reliable objective criterion to evaluate the debtor's "good faith" in complying with the Fund's LIA policy, as some suggested in Argentina's case.

It is also important to note that any debt-restructuring proposal requires important fiscal efforts. This makes "ownership" of the policies to be taken by the government essential particularly in democratic societies and requires that due consideration be given to the interests of all of the country's creditors and stakeholders, including pensioners, workers and direct investors (both domestic and foreign).

In short, it may not be possible to reconcile the new paradigm that considers the use of public funds to bail out private creditors erroneous with the expectation that public debtors achieve very high levels of acceptance in a restructuring from private creditors.

Specifically in Argentina's case, some argued that it was necessary for the country to ensure a very high level of acceptance of its restructuring proposal so as to regain rapid access to capital markets. The assumption was that the more generous its restructuring

proposal was, the less reluctant that potential investors and creditors would be to provide new financing to Argentina. This assumption was, to say the least, questionable as it failed to acknowledge the tension between the “attractiveness” of a restructuring proposal and the debt-sustainability or capacity of a debtor to honor its terms. The more attractive the proposal is for creditors, the more likely that the debtor will have to depend on new borrowing and, consequently, the more compromised its future payment capacity will result.¹⁷

With the benefit of hindsight, we can say that the game of appeasing the creditors with extremely generous promises, beyond constituting a breach of good faith¹⁸, does not pay and that markets, far from penalizing a tough negotiating debtor, line up to lend again when prudent fiscal policies ensure improved financial, i.e., fiscal and debt sustainability.

In short, yielding to political pressure of private creditors ends compromising debt sustainability and future access to capital markets. To be consistent with the “new paradigm” the international community should only support a restructuring agreement that, with prudent fiscal policies in place, would ensure the debtor’s capacity to restart economic growth, on which its capacity to honor its liabilities ultimately depends.

¹⁷ I acknowledge that some potential creditors, in particular professional investors, may be willing to take advantage of the short-term bonanza that could follow a debt-restructuring proposal that defaulted creditors could find particularly appealing. However, they will surely be ready, at the same time, to quickly revert their positions at the first symptoms of distress that would likely appear at the first hint of the country’s difficulty to borrow enough to honor its restructured commitments.

¹⁸ The “careless promisor” attitude is a breach of good faith in itself. In French civil law, the “overriding rule is that ‘one must not create the expectation that a contract will be forthcoming unless one so intends’”. Very much in the same line, in German law, Jhering, the undisputed father of the doctrine of “*Culpa in Contrahendo*” (loosely translated as “fault in negotiating”), considers that a “careless promisor”, namely a party making promises that are unlikely to be fulfilled, would be acting with “lack of diligence”. It follows that a “careless promisor” would be acting in bad faith and, therefore, liable.

CLOSING REMARKS

Learning from experience is, of course, of the utmost importance. There are several lessons that we could draw from Argentina's experience in dealing with the aftermath of the crisis.

The Fund seems to be still undecided on what a role it should have, if any, in the event of a default from a member country. This lack of clarity puts the Fund in a hesitant and unclear position. It no longer acts as a lender of last resort out of the fear of inducing a moral hazard by absorbing private risks or, even worse, private losses. However, it does not have yet a clear hands-off policy. It uses, albeit hesitantly, its financial leverage to exercise pressure on the sovereign debtor in distress in favor of private financial interests. This is, obviously, in response to pressures that the Fund itself gets from some of its major shareholders that are unhappy seeing that while their citizens bear the cost of the default the Fund and the other IFIs are paid in full in a timely manner.

Last but not least, it should also be noted that the advice provided by the Fund in the immediate aftermath of the crisis was neither timely nor appropriate and, fortunately, was rarely followed by Argentina's authorities. This is not to imply that the staff's position was capricious but that the Fund's view relied on a wrong assessment of Argentina's economic, social and political situation. In their view, Argentina had a large monetary overhang that would rapidly be translated into high inflation if monetary policy were relaxed. Argentina's authorities considered that there was, instead, a large pent up demand and excess production capacity which, in the context of responsible fiscal policies, would absorb a substantial growth of money supply and jump start a rapid recovery without risking high inflation. With the benefit of hindsight we now know evidence has proven that Argentina's government was right in its assessment.

To put it in a nutshell, the most important lesson that could be distilled from Argentina's most recent experience is that the Fund doesn't seem to be entirely prepared to deal with a full-blown crisis.

The purpose of this analysis is not to dig into past mistakes. On the contrary we wish to look ahead, learning from the past. Our only aim is to invite reflection on how to prevent these mistakes from happening again.

In order to move forward we should take stock and learn from Argentina's sad experience. We should ensure that the Argentina's difficulties in dealing with the aftermath of the crisis are truly capitalized as a learning experience for the Fund. It is in the interest of us all to ensure that the international community draws the correct lessons from Argentina's crisis so as to be well prepared to promptly and efficiently advice other member countries' authorities that could, hopefully not, confront analogous situations in the future. In particular, by following the philosophy of its own guidelines: "The Fund shall be guided by the principle that the member is responsible for the design and implementation of its economic policies."¹⁹

¹⁹ Guidance on the Design and Implementation of IMF Conditionality, June 3, 2002.

ANNEX

IFI's Argentina: Net Transfers

In millions of US\$

Year	IMF	BIRF	BID	TOTAL
2002	1,606	1,445	1,024	4,074
2003	831	1,387	322	2,539
2004	2,558	296	593	3,446
2005*	2,689	526	278	3,493
Total	7,683	3,654	2,216	13,553

(*) January - August 2005.

Note: Positive figures denote net payments to the IFI's.

Exchange rate: 1 SDR = 1.46414 US\$

Net Payments to the IMF

In US\$ million

	2002	2003	2004	2005*	Total
Argentina	1,605.5	830.5	2,557.8	2,689.2	7,683.1
Brazil	-12,188.8	-4,329.2	5,497.4	8,688.9	-2,331.7
Turkey	-6,420.4	983.4	4,409.1	4,915.0	3,887.1
Uruguay	-1,736.5	-378.3	-56.3	174.6	-1,996.5
Indonesia	1,371.1	-363.6	1,245.0	956.7	3,209.2

Note: Positive figures denote net payments from the country to the IMF, whereas negative figures imply net flows from the IMF to the country.

* January to August 2005

Exchange Rate: 1 SDR = 1.46414 US\$